OTTAWA and the PROVINCES

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Volume 2

Ontario Economic Council

**Edited by Thomas J. Courchene.
David W. Conklin, and
Gail C. A. Cook.**

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OTTAWA AND THE PROVINCES: THE DISTRIBUTION OF MONEY AND POWER

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Ottawa and the Provinces: The Distribution of Money and Power

Volume 2

Edited by Thomas J. Courchene
David W. Conklin
Gail C.A. Cook

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OTTAWA AND THE PROVINCES:
THE DISTRIBUTION OF MONEY AND POWER

PART VI
HEALTH CARE IN THE 1990s

Rationalizing the health-care system

Greg L. Stoddart

To an outsider, the existing commentary on the Canadian health-care system must seem confusing. We often note our substantial accomplishments. Canadians are well protected against the uncertain and potentially disastrous medical and hospital costs of illness by a 'first-dollar' insurance plan. We have distributed the cost of the plan on a well-accepted ability-to-pay system. By international standards, Canadians enjoy relatively high levels of health status, difficult though it is to measure; certainly there is no reason to believe that we are less healthy than other populations. We have developed a stock of well-trained, dedicated health-care providers and administrators. The public repeatedly indicates that the health-care insurance and delivery system is one of our most important and satisfactory programs. Finally, throughout its first decade of operation, Canada's publicly funded health-care system managed to control health-care expenditures at a roughly constant share of the gross national product. Both the record and the system are the envy of most industrialized nations. What could be wrong?

Yet we repeatedly and increasingly hear that there is a better way than our current path, that first-dollar insurance is neither necessary nor efficient, that government has gone too far both in providing

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insurance and in involving itself in the practice of medicine. Key providers are dissatisfied with the administration of the system. The medical profession, a somewhat reluctant co-operator at the inception of the universal, public health-insurance program, is frustrated by what it views as unnecessary bureaucratic procedures and government niggardliness about fee levels and extra-billing privileges. Allied health professionals also are dissatisfied, claiming that overreliance on and a surplus of physicians are preventing the appropriate and efficient expansion of their roles. Advocates for low-income groups and for others who seek particular types of services in certain geographic areas suggest that access to health care is neither universal nor unimpeded. Both administrators and providers claim that overly restrictive budgetary controls are causing a deterioration in the quality of care. Yet even as they listen to persistent charges of underfinancing of health care, provincial governments insist that a lid must be put on spending for it, particularly because it is such a large factor in government deficits.[1]

FINANCING WITHOUT ORGANIZATION

Nothing is ever quite as good or as bad (or as simple) as it appears. The elusive truth about Canadian health care is likely somewhere between the two poles of a popular, equitable system that delivers high-quality care and one that is cheating practitioners and patients while draining government coffers. Although Canadians are often said to spend as much time studying and commenting upon their health care as they do delivering it, a brief retrospective on the evolution of our system and its performance may explain some of the paradoxical commentary.

Medicare in the 1970s

During the years leading up to the completion of a universal, public medical- and hospital-insurance system (often referred to as medicare), the overriding concerns of those involved were the protection of patients from the financial risks of ill health and the provision of access to necessary care for all Canadians. The result was the establishment, by 1971, of a national network of provincial health-insurance plans, publicly funded and administered, providing first-dollar coverage for medical and hospital services.[2]

Although the introduction of medicare significantly changed health-care financing, the new arrangements left the organization and delivery of health services largely unchanged. With few exceptions, the provinces adopted a 'pay-the-bills' philosophy in which decisions about provision – which services, in what amounts, produced how, by whom, and where – were viewed as the legitimate domain of physicians and hospital administrators. Indeed, the maintenance of a good working relationship with health-care providers was, and continues to be, an important objective of provincial governments. In addition, the regulatory apparatus governing health care, including the self-regulation of medical practice, was left largely unaffected.

When medicare was introduced, both health-care providers and government took considerable pride in their joint accomplishment in the public interest, although both groups may have felt uneasy about the future – the former wary of their professional freedom and the latter leery of the open-ended fiscal arrangements of reimbursing hospitals on the basis of costs and physicians on the basis of fees-for-service. During the 1970s, however, at least five developments strained the relationship between government and providers and made costs the dominant issue in Canadian health care.[3]

First, it became apparent that government had limited, though powerful, instruments available to control costs. What began as dialogue about the appropriate levels for physicians' fees and hospital budgets became difficult negotiations, if not outright confrontations. Second, the federal working document *A New Perspective on the Health of Canadians* (Canada 1974) lent important support to questions about whether additional spending on medical and hospital services would provide increased health benefits. Third, accumulating information from health-services research strongly suggested that alternative organizational models for health-care delivery, often involving changes in traditional payment methods, could reduce costs without sacrificing the quality of care. Fourth, almost everyone came to recognize that the population's health needs and their distribution, especially across age groups, were changing in a manner that would seriously challenge the existing system's ability to meet them in the not-too-distant future. Finally, the 1977 change in the federal-provincial arrangements for

established programs financing increased the incentive for provincial governments to rationalize the health-care system.[4]

Medicare in the early 1980s

Since the beginning of the 1980s, the difficulties of the 1970s have become even more pronounced. Although governments have made significant attempts to limit health-care spending through reimbursement controls and supply restrictions, primarily on physicians and hospitals, these have been only moderately successful. Moreover, their effectiveness as long-run policy instruments is suspect.

Thus, the current situation suggests that the rationalization of Canada's health-care system will be a difficult and lengthy task, requiring hard choices. Consider the following:

- Those responsible for providing and administering the provision of specific health services to patients exert steady pressure on government to increase its resource commitments in order to maintain existing styles of delivery, existing incomes, or both.

- The main policy instruments currently available to or at least employed by government for accomplishing change are relatively blunt fiscal measures (such as making decisions on fee levels and budgets and setting controls on the numbers of providers and hospital beds) backed only by a willingness to engage in confrontation.

- The sheer size of governments' financial commitments to existing programs severely limits the funds available for innovation or experimentation with alternative financing and delivery arrangements, even if they are potentially more cost-effective.

- The health-care system itself has few internal adjustment or equilibrating mechanisms to effect the reallocation of existing budgets to improve efficiency.

- Perhaps most important, no consensus exists among the system's numerous actors as to which trade-offs and reallocations might be in the public interest. This lack of agreement is not surprising considering that all the key actors – providers, administrators, patients, and bureaucrats – are behaving quite rationally, given their

legitimate concerns for their own welfare, the performance expectations imposed upon them, and the incentives they face.

Medicare today: at a crossroads

From all indications, health care in Canada appears to be at a crossroads between a reorientation of the system through the increased privatization of financing and the preservation of what many analysts view as a basically sound system, though one in need of structural reform to address efficiency issues directly.

The objectives of this paper are to identify key issues that must be dealt with in any attempt to rationalize the health-care system and to discuss alternative policies, both broad strategies and specific proposals, for addressing these issues. It is not intended to be a catalogue of inefficiencies nor a subsector-by-subsector examination of health-care spending, although these exercises might be worthwhile. Rather, its purpose is to provide a framework for and stimulation of discussion and debate on the future evolution and refinement of the health-care system. It focuses on issues and alternatives in the Ontario system; however, given the nature and historic development of health-care organization and financing in Canada, the main analytical themes are equally relevant to the other provinces.

The paper proceeds as follows. First, aggregate expenditure data are reviewed in order to assess our record of cost control. The discussion of this record underlines the importance of sole-source funding in controlling health-care expenditures but questions the viability of continuing the present approach to cost containment. Moreover, it suggests that cost containment is not the same as efficiency improvement. The distinction is an important one, since there is good reason to believe that we could be obtaining better value for the money currently being spent in the health-care system and that we have not taken full advantage of existing knowledge on efficient ways of delivering health-care services and maintaining or improving health status.

These observations lead to a consideration of the nature of health care and markets for health-care services. Why has more of what we know not been implemented? An examination of the process of health-care utilization yields several observations relevant to future attempts at rationalization. The extremely wide latitude in practice

style that existing medical knowledge and technology affords providers, coupled with the difficulty of defining health-care needs and measuring outcomes, can dramatically vary the cost of achieving a given level of health for the population. Coupled with the incentive structure that now faces patients and providers, it can create an industry capable of indefinite expansion.

A discussion of potential avenues for rationalization follows; it concentrates on ways to alter the current incentive structure, the management process, or organizational entities in the health-care system. The basic theme is the need to link fiscal responsibility to decision-making authority in the delivery of health-care services.[5] Since this may be accomplished in several ways, none of which is without drawbacks, the discussion touches briefly on the spectrum of policy directions open to government; although the choice is sometimes characterized as one between increased regulation and increased use of market forces, the key question is who is to control patterns of health-service delivery. The discussion of the spectrum of policy directions further suggests that proposals for the application of market forces in health care are often incomplete and misleading and that characterizations of future policy choices as 'more market or more state' are miscast since there may be scope for significant development of market forces *within* a publicly financed system. The section concludes with the observation that, regardless of the policy direction or specific mechanisms government adopts, a long-term plan for addressing efficiency issues in the health-care system is overdue.

Of course, the general federal-provincial environment and specifically the fiscal arrangements for health-care expenditures remain important considerations in any provincial planning or action aimed at rationalizing the system. Thus, the final section explores some efficiency implications of the most recent development in this area, the passage of the Canada Health Act. It suggests that the act may affect efficiency to the extent that its passage freezes in place obstacles to alternative models of financing and delivery.

COST CONTAINMENT OR EFFICIENCY IMPROVEMENT?

One of the most striking features of the Canadian health-insurance system has been its ability, until very recently, to hold national health-care expenditures to a roughly constant share of GNP. As shown in

Table 1, expenditures in Canada remained at approximately 7 per cent of GNP throughout the 1970s; Figure 1 illustrates the sharp contrast with their steady growth during the previous decade, before the completion of medicare.[6] (A similar picture emerges for Ontario, as shown in Table 2 and Figure 2).

In this respect, the experiences of Canada and the United States differ markedly. As shown in Figure 1, the growth in U.S. health-care expenditures as a share of GNP, which paralleled that of Canada before 1971, continued steadily throughout the 1970s, and the figure now exceeds 10 per cent. This difference is particularly interesting since many commentators suggest that adopting a system more like the United States', with greater cost-sharing by patients through deductibles or co-insurance, would allow better control of health-care spending. Such is apparently not the case. At the least, it appears obvious that direct charges to patients do not in themselves control expenditures.[7]

Evans (1982) has analysed in detail the mechanisms through which Canada has accomplished this global expenditure control. His separate discussions of the real and nominal components of health-care expenditures suggest that it has been pressure on medical fee schedules and incomes, rather than labour use, and on hospitals' physical capacity and budgets, rather than patterns of hospital practice, that has accounted for the Canadian system's relative success in controlling expenditures.[8] The key factor has been the degree of reimbursement control (rather than regulation *per se* or incentives to providers or patients) that the monopsonist governments exert in what is essentially a sole-source funding system.[9]

Given this apparently successful record of expenditure control, one can reasonably ask why health-care costs remain such a dominant issue in Canada. There are at least three answers. First, data for the most recent years available suggest an upturn in costs. Provisional 1982 data indicate that national health expenditures reached 8.4 per cent of GNP (Table 1) – although the 1981 figure for Ontario remained at 6.9 per cent (Table 2) – and this change does not appear to be solely the result of changes in GNP. Moreover, although Anti-Inflation Board controls provided some breathing space for provincial governments during the 1970s, negotiations with physicians and hospitals have since become increasingly confrontational and there is little reason to believe that tensions between the parties will lessen in

TABLE 1
Canada's total health expenditures, by category (percentages of GNP)

	1970	1971	1972	1973	1974	1975	1976
Total health expenditures	7.30	7.54	7.40	7.06	6.95	7.49	7.38
Total personal health-care expenditures	6.36	6.57	6.51	6.21	6.10	6.61	6.52
Institutions	3.81	3.88	3.86	3.73	3.79	4.20	4.17
General and allied special hospitals	2.67	2.74	2.72	2.62	2.68	3.01	3.01
Mental hospitals	0.48	0.47	0.45	0.43	0.41	0.42	0.34
Tuberculosis hospitals	0.03	0.02	0.01	0.01	0.00	0.00	0.00
Federal hospitals	0.11	0.11	0.10	0.09	0.08	0.08	0.07
Homes for special care	0.52	0.55	0.58	0.58	0.61	0.69	0.75
Professional services	1.65	1.77	1.77	1.65	1.55	1.63	1.57
Physicians'	1.21	1.32	1.32	1.20	1.12	1.16	1.10
Dentists'	0.31	0.33	0.33	0.34	0.33	0.36	0.36
Chiropractors'	0.04	0.04	0.04	0.04	0.04	0.04	0.04
Optometrists'	0.05	0.05	0.05	0.05	0.04	0.04	0.04
Podiatrists'	0.00	0.00	0.00	0.01	0.01	0.01	0.01
Osteopaths'	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Nursing	0.02	0.02	0.02	0.02	0.01	0.02	0.02
Physiotherapists'	*b*	*b*	*b*	*b*	*b*	*b*	*b*
Drugs and appliances	0.91	0.92	0.88	0.83	0.76	0.79	0.78
Prescribed drugs	0.43	0.43	0.40	0.38	0.34	0.35	0.35
Nonprescribed drugs	0.38	0.38	0.36	0.34	0.31	0.32	0.32
Eyeglasses	0.07	0.08	0.09	0.08	0.08	0.08	0.08
Hearing aids	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Health appliances and other prostheses	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Other health costs	0.94	0.97	0.89	0.85	0.85	0.88	0.86
Prepayment administration	0.12	0.13	0.13	0.12	0.12	0.13	0.11
Public health	0.23	0.23	0.22	0.20	0.19	0.22	0.25
Capital expenditures	0.43	0.44	0.38	0.37	0.38	0.37	0.34
Health research	0.08	0.08	0.09	0.08	0.08	0.08	0.07
Miscellaneous health costs	0.08	0.08	0.08	0.08	0.08	0.08	0.09

TABLE 1 (continued)

	1977	1978	1979	1980	1981[a]	1982[a]
Total health expenditures	7.39	7.36	7.21	7.48	7.60	8.44
Total personal health-care expenditures	6.52	6.49	6.37	6.53	6.65	7.41
Institutions	4.13	4.09	3.99	4.11	4.20	4.65
General and allied special hospitals	3.02	2.98	2.91	3.01	3.06	3.38
Mental hospitals	0.20	0.18	0.15	0.14	0.06	0.06
Tuberculosis hospitals	0.00	0.00	0.00	0.00	0.00	0.00
Federal hospitals	0.08	0.06	0.06	0.05	0.05	0.05
Homes for special care	0.83	0.86	0.87	0.91	1.04	1.15
Professional services	1.60	1.61	1.60	1.65	1.66	1.84
Physicians'	1.10	1.10	1.08	1.11	1.10	1.24
Dentists'	0.39	0.41	0.42	0.43	0.44	0.47
Chiropractors'	0.04	0.04	0.04	0.04	0.04	0.05
Optometrists'	0.04	0.04	0.04	0.04	0.04	0.05
Podiatrists'	0.01	0.01	0.01	0.01	0.01	0.01
Osteopaths'	0.00	0.00	0.00	0.00	0.00	0.00
Nursing	0.01	0.01	0.01	0.02	0.02	0.02
Physiotherapists'	*b*	0.00	0.01	0.01	0.01	0.01
Drugs and appliances	0.80	0.79	0.78	0.76	0.79	0.92
Prescribed drugs	0.35	0.35	0.35	0.34	0.36	0.41
Nonprescribed drugs	0.33	0.33	0.32	0.31	0.33	0.38
Eyeglasses	0.09	0.09	0.08	0.08	0.08	0.09
Hearing aids	0.01	0.01	0.01	0.01	0.01	0.01
Health appliances and other prostheses	0.02	0.02	0.02	0.02	0.02	0.02
Other health costs	0.87	0.87	0.85	0.95	0.95	1.03
Prepayment administration	0.12	0.11	0.10	0.10	0.12	0.12
Public health	0.26	0.26	0.26	0.26	0.26	0.27
Capital expenditures	0.32	0.33	0.31	0.41	0.39	0.44
Health research	0.08	0.08	0.08	0.08	0.09	0.09
Miscellaneous health costs	0.09	0.09	0.09	0.09	0.09	0.10

a Data are provisional
b Data not available
SOURCE: Canada (1983, table 6).

Figure 1
Canadian and U.S. health expenditures as percentages of GNP

NOTE: Canadian data for 1981 and 1982 are provisional.

SOURCE: Canada (1983, figure 3).

TABLE 2
Ontario's total health expenditures, by category (percentages of GDP)

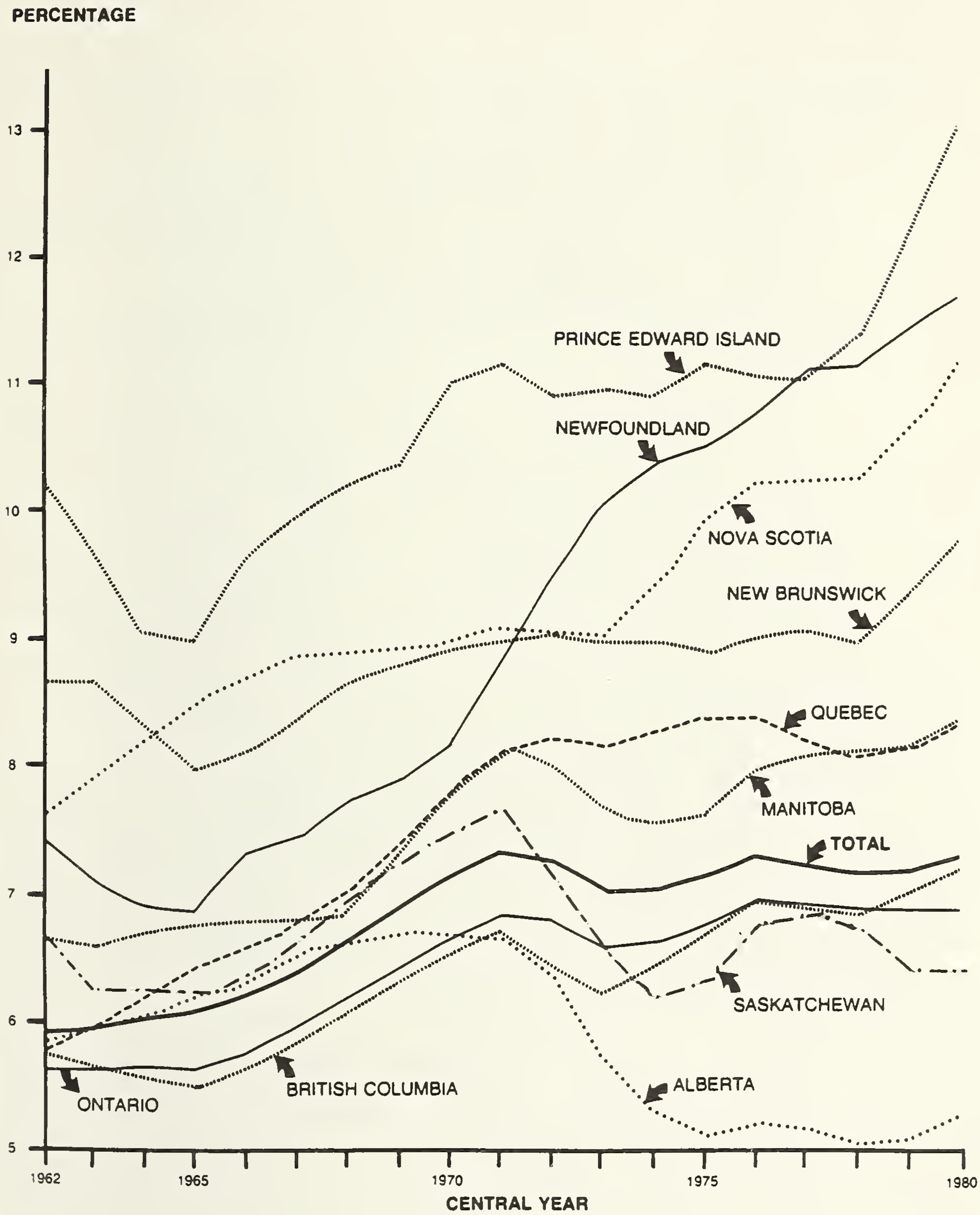
	1970	1971	1972	1973	1974	1975
Total health expenditures	6.72	6.96	6.82	6.50	6.42	6.98
Total personal health-care expenditures	5.82	6.03	5.91	5.67	5.64	6.24
Institutions	3.32	3.46	3.43	3.32	3.40	3.80
General and allied special hospitals	2.35	2.45	2.44	2.34	2.40	2.71
Mental hospitals	0.44	0.47	0.46	0.44	0.44	0.46
Tuberculosis hospitals	0.02	0.01	0.00	0.00	0.00	0.00
Federal hospitals	0.06	0.06	0.06	0.05	0.05	0.06
Homes for special care	0.45	0.47	0.48	0.49	0.51	0.58
Professional services	1.69	1.76	1.70	1.61	1.53	1.63
Physicians'	1.24	1.28	1.23	1.12	1.08	1.14
Dentists'	0.34	0.37	0.36	0.38	0.35	0.38
Other professional	0.11	0.11	0.11	0.10	0.10	0.11
Drugs and appliances	0.81	0.81	0.78	0.75	0.71	0.81
Prescribed drugs	0.38	0.37	0.35	0.33	0.32	0.36
Nonprescribed drugs	0.35	0.34	0.32	0.31	0.29	0.33
Eyeglasses	0.06	0.07	0.08	0.08	0.08	0.08
Hearing aids	0.01	0.01	0.01	0.01	0.01	0.01
Health appliances and other prostheses	0.01	0.02	0.02	0.02	0.02	0.02
Other health costs	0.91	0.93	0.90	0.83	0.77	0.74
Prepayment administration	0.13	0.14	0.13	0.12	0.11	0.12
Public health	0.22	0.21	0.21	0.19	0.17	0.18
Capital expenditures	0.40	0.43	0.40	0.36	0.34	0.29
Health research	0.07	0.07	0.08	0.07	0.07	0.07
Miscellaneous health costs	0.09	0.08	0.08	0.08	0.08	0.09

TABLE 2 (continued)

	1976	1977	1978	1979	1980	1981[a]
Total health expenditures	6.86	6.92	6.96	6.80	6.88	6.91
Total personal health-care expenditures	6.15	6.18	6.22	6.08	6.14	6.18
Institutions	3.77	3.75	3.73	3.61	3.63	3.72
General and allied special hospitals	2.63	2.63	2.59	2.49	2.51	2.57
Mental hospitals	0.43	0.25	0.23	0.20	0.20	0.07
Tuberculosis hospitals	0.00	0.00	0.00	0.00	0.00	0.00
Federal hospitals	0.05	0.04	0.03	0.03	0.04	0.04
Homes for special care	0.66	0.82	0.88	0.89	0.89	1.04
Professional services	1.55	1.59	1.62	1.64	1.72	1.72
Physicians'	1.06	1.06	1.08	1.08	1.14	1.15
Dentists'	0.38	0.42	0.43	0.44	0.46	0.46
Other professional	0.11	0.11	0.11	0.12	0.12	0.11
Drugs and appliances	0.83	0.84	0.87	0.83	0.79	0.74
Prescribed drugs	0.37	0.38	0.39	0.37	0.35	0.32
Nonprescribed drugs	0.34	0.34	0.36	0.34	0.32	0.30
Eyeglasses	0.08	0.09	0.09	0.08	0.08	0.08
Hearing aids	0.01	0.01	0.01	0.01	0.01	0.01
Health appliances and other prostheses	0.02	0.02	0.02	0.02	0.02	0.02
Other health costs	0.71	0.74	0.73	0.72	0.73	0.73
Prepayment administration	0.09	0.10	0.08	0.09	0.09	0.10
Public health	0.21	0.22	0.20	0.22	0.21	0.21
Capital expenditures	0.25	0.25	0.27	0.24	0.25	0.24
Health research	0.07	0.07	0.08	0.07	0.07	0.07
Miscellaneous health costs	0.09	0.10	0.10	0.10	0.11	0.11

a Data are provisional
SOURCE: Canada (1983, table 47).

Figure 2
Provincial health-care expenditures as percentages of GDP
(three-year moving averages, centred on 1962-80)



NOTE: 1981 components are from provisional data.

SOURCE: Canada (1983, figure 9).

future. The long-run viability of a cost-containment policy that depends primarily upon toughness of political will seems suspect at best, given the nature of health-care services and the established positions of the medical profession and the major health-care institutions.

A second reason for concern is that government's ability to pay is becoming increasingly strained. In these times of deficit, the health-care sector receives particular attention by virtue of its size – for Ontario, approximately 30 per cent of the provincial budget – and its recent growth – for Ontario, a 74-per-cent increase in expenditures over the five years ending in 1982 (see Ontario 1982a).[10]

Finally (and perhaps of most significance to the discussion in this paper), concern over the current level of health-care expenditures derives from the knowledge that we could be buying both more health care and more health with our present resource outlay. As analysts of health care have repeatedly noted, we frequently do not obtain maximum value for money spent on health services.[11] One reason is the limited scope remaining for curative services to affect health status at the margin, given the multifactorial nature of many of the leading causes of morbidity and mortality.[12] Perhaps more important, however, are causes related to the services *per se* and their delivery: (1) some services are not efficacious or, more often, are provided and utilized beyond efficacious levels or frequencies; (2) for many efficacious services, the procedures, personnel, or settings commonly used for delivery do not constitute the most cost-effective methods available; (3) we rely on a fee-for-service, solo-practitioner system, although alternative organizational models have the potential to reduce inefficient delivery patterns.

Examples of evidence in all three categories are not hard to find. The rates of performance of many common surgical procedures and the lengths of hospital stays for several conditions have been repeatedly questioned (Roos and Roos 1981; Enthoven 1978). A recent evaluation (Gilbert et al. 1984) suggests that efficacious health care can be provided during a normal child's first two years through a protocol of fewer well-baby examinations than the ten currently paid for by the Ontario Health Insurance Plan. A synthesis of several existing studies suggests that some components of the periodic health examination are utilized well beyond their efficacious frequencies. (These and other examples illustrate what Enthoven

[1978] has labelled 'flat of the curve medicine', a situation in which expenditures yield few or no discernible health benefits at the margin.) There is also evidence to suggest that we take far less than full advantage of such cost-effective methods as day-care surgery (Evans and Robinson 1980), primary care delivered by nurse practitioners (Spitzer 1978), and delivery models alternative to solo, fee-for-service practice (Hastings et al. 1973; Luft 1981).

Given the weight of such consistent and cumulative results, the recent Parliamentary Task Force on Federal-Provincial Fiscal Relations (Canada 1981) seems justified in concluding that we should make greater efforts to implement what we already know before we increase our resource commitments to the health-care system.

CAVEATS ABOUT THE MARKET FOR HEALTH SERVICES

Rationalizing patterns of health-care delivery along any of the three lines suggested above will not be a straightforward task, however, because of the nature of health and health care themselves and because of the characteristics of the 'market' in which health-service utilization is determined.

Health-care expenditures – and the incomes that they generate – are the result of a series of interactions between patients and providers initiated by the incidence of illness and perceptions of health needs. This process of health-care utilization is sometimes seen as purely technical or as purely economic. In the former view, illness occurs with a predictable incidence in the population; affected individuals present well-defined problems to providers, who, in turn, apply a unique set of inputs from a well-defined matrix of medical technology to resolve any specific condition. Thus, the efficient satisfaction of health-care needs is basically an engineering problem. In the latter view, fully informed consumers have 'tastes' for health care and demand services, according to their willingness and ability to pay, from suppliers who are likewise sensitive to price signals. Competition among suppliers results in technical efficiency in production, while the price system and consumer preferences and valuations ensure allocative efficiency – that is, that the proper types of services are used in the proper amounts.

Both views are obviously extreme oversimplifications of the utilization process, but as Fuchs (1972; 1974) and Evans (1974a; 1984) point out for the United States and Canada respectively, analyses and

policy prescriptions in this field have often implied one view or the other. In reality, decisions by both patients and providers reflect a mixture of technical, economic, and behavioural influences and are made under considerably more uncertainty and with much less precision than is often recognized.

The nature of markets for health services and the special characteristics of the commodity of health care are extensively discussed in the literature on health economics;[13] a full development of the subject here is, therefore, neither necessary nor possible. What is important, however, is that certain characteristics of the process by which health care is demanded and supplied have serious implications for attempts to improve the efficiency of the system. Three specific features deserve special attention.

1 Providers of health care have much more information than consumers about what services exist, which services are appropriate for which problems, and what those services will accomplish. Consumers may still be the best judges of their own welfare, but this statement applies only to the final product, 'health', not the intermediate product, 'health services'. Consumers are generally ill informed about the necessity of specific services and their capacity to affect health; thus, we cannot in general rely on consumer valuations in determining the optimal level and mix of specific health-care services. This asymmetry of information results in providers' having an agency role – sometimes referred to as 'producer sovereignty' – that gives them significant discretionary power over the utilization process and, thereby, a major role in determining levels of health-care expenditures. An important implication of this situation is that any attempt to alter patterns of health-care delivery and utilization through incentives to consumers *alone* is likely to be ineffective.

2 Existing medical technology is not a precise science. Both the state of the art and the available human and capital inputs allow considerably more latitude in 'practice style' than many people acknowledge. In other words, there are both low-cost and high-cost 'styles' of providing the same health services. For this reason, spending less does not automatically mean getting less, in either the quantity or the quality of services. (The latter point is particularly significant in discussions such as the present one, since opponents of change in the health-care system frequently attempt to create the

impression that efficiency improvements entail a lessening of the quality of care. This need not be the case.)

3 Basic concepts, such as 'health' and 'need', which are fundamental to the analysis of the health-care system, are extremely difficult to define and to measure. The World Health Organization's (1958) definition of health perhaps best illustrates this. If indeed health is 'not simply the absence of disease but a state of complete physical, mental, and social well-being', there is literally no end to the 'good' things, including the provision of health care, that one can do for people's health. Moreover, because health status is difficult to quantify, those who discuss and attempt to measure it often substitute process for outcome. More health-care services are unjustifiably equated with better health. The need for care is also difficult to define and measure: in practice, it tends to be determined largely by the providers of care on the basis of the capability of existing and expanding technology.

Because of these difficulties, when efficiency gains are made in the health-care sector, the resources saved must be removed from it. Otherwise, they will be redeployed into activities whose marginal benefits are often unknown and difficult to evaluate.

It is important to keep these caveats in mind when considering specific proposals for rationalizing health care.

One must also recognize two broader considerations. First, since health care is but one factor in the production function for health (along with environmental, lifestyle, and biologic factors), future improvements in population health status will require more from government than the rationalization of the health-care system. They will also require the co-ordination of health policy with other government policies, such as those on agriculture and the environment. This interrelationship of the health sector with other sectors of the economy constitutes an important area for future research.

Second, rationalization of the health-care system must recognize important equity objectives within the current system. In particular, existing opinion appears to indicate that universal coverage, unimpeded access, and the avoidance of two-class medicine are Canadian counter-examples to the statement that every principle has its price.

PRIORITIES FOR CHANGE

As the preceding sections make clear, there is little reason to expect improvements in the patterns of health-care utilization and expenditure unless changes are made to alter the incentives facing key participants, to introduce new forms of organization into the delivery system, or both. In a system characterized by financing without organization, priority must be given to rationalizing the processes through which providers and institutional administrators manage utilization. The authority and discretion to make the production decisions that determine utilization and expenditures must be linked with the financial responsibility for those decisions.

In this respect, the existing incentives in our health-care system are particularly perverse. Fee-for-service reimbursement of physicians and cost-reimbursement of hospitals through negotiated global budgets contain little incentive for either technical or allocative efficiency. This situation is exacerbated by the lack of any incentives for physicians to make efficient use of hospitals, which seem a free, complementary input at their disposal. Finally, even if physicians and institutional managers did face incentives that encouraged the efficient production and delivery of services, our tax-financed, first-dollar-coverage health insurance gives patients no incentives to choose efficient sources and styles of care.

Given this environment, the surprise is not that inefficient patterns of resource allocation exist, but that they are not worse; not that global expenditure-control is now becoming extremely difficult and confrontational, but that it has lasted this long. The lid stayed on so long at least in part because the health-care system is operated and utilized by dedicated professionals and conscientious consumers who do understand that resources are not infinite. Unfortunately, they are given few mechanisms or incentives for aligning their own goals and welfare with the social goal of efficiency.[14]

The preceding analysis suggests four high-priority areas for change, which this section identifies as a framework for the discussion of specific issues and alternatives. The analytic themes are changes in payment methods and adjustments to supply, applied to both physicians and institutions.[15] The involvement of consumers is deferred to the following section, which examines the broad policy choices available to government for accomplishing change at the system level.

To suggest that change is necessary for efficiency improvement is not to suggest that it can be accomplished either easily or rapidly. Some of the mechanisms discussed below would require phasing in over time; others pose unanswered questions and the need for further research on implementation, effectiveness, and impact. Perhaps most important, changes in the levels or types of health-care expenditures will inevitably create friction as they affect incomes in the system.

Changes in payment methods for physicians

Bird in Bird and Fraser (1981) concludes that fee-for-service reimbursement of physicians is incompatible with our present financing arrangements for health care. Whether or not this is so, it seems highly desirable to make increased use of alternative payment methods, such as capitation and salary. The tendency of fee-for-service payment to result in overprovision of services is well-known.[16] Of course, no single method of payment is free from all defects, and debates will no doubt continue about whether salary and capitation provide incentives to underservice patients. On balance, however, it seems fair to say that substantial evidence of such underservicing does not exist, and that alternatives to fee-for-service payment, especially capitation, have much to offer on efficiency grounds.

Since capitation and salary are payment methods not well suited to solo practice, their increased use depends largely on the expansion of alternative organizational models for delivering care, such as health service organizations (HSOs) and community health centres (CHCs).[17] Some initial development of such alternatives has been done in Ontario, but scope exists for considerably more.

Advocates of these alternatives claim that they improve efficiency by reducing unnecessary utilization (especially hospital admissions) and by lowering the production costs of necessary services through a more appropriate input mix (for example, using nurse practitioners). Although evidence from the Health Maintenance Organization (HMO) experience in the United States (Luft 1981; Manning et al. 1984) tends to confirm these and other claims, to date the only systematic evaluation of an Ontario HSO has been of the Group Health Association clinic in Sault Ste. Marie. Begun as a prepaid group practice before the introduction of medicare, it subsequently became a capitation-based HSO. Evaluations of its performance,

contrasted with that of fee-for-service physicians in Sault Ste. Marie, have consistently indicated that capitation arrangements can lower health-care costs, even though the clinic's full potential has yet to be realized because existing financing arrangements constrain its operation (Hastings et al. 1973; Vayda 1977; Barer 1981; Lomas 1984).

The U.S. and Sault Ste. Marie results strongly suggest that we should be paying more attention to organizational models that embody payment methods other than fee-for-service. Yet, as Vayda and Lomas indicate and as the paucity of such models in Canada attests to, their development is difficult in the current environment. The optimal role of such models is also not clear. In the United States, where HMOs contract directly with patients, most provide services to employed people who are in dual-choice situations. In Ontario, however, HSOs often serve low-income groups or are used to deliver special health programs. I have suggested elsewhere (Stoddart 1983) that a pluralistic system, with HSOs and CHCs competing with fee-for-service physicians under the umbrella of a publicly financed, publicly monitored system, might offer significant advantages.

Changes in payment methods for institutions

In analyses parallel to those of the efficiency implications of fee-for-service payment of physicians, several authors have pointed out the deficiencies of the cost-reimbursement methods traditionally employed for the payment of Canadian hospitals and other health-care institutions (Pauly 1970; Berki 1972; Evans and Walker 1970). They generally conclude that such methods neither encourage nor reward efficient institutions. But although identification of 'poor' payment systems is not difficult, the design of 'better' ones has posed a more formidable challenge. A substantial literature exists on the subject; however, only recently have techniques for hospital-cost analysis reached a sophistication that allows the design of experimental reimbursement systems.[18]

These systems employ detailed information on several dimensions of the case mix of hospitals and their effects on costs to design prospective rates of reimbursement for different types of patients. In a manner analogous to the movement from fee-for-service payment of physicians to capitation, the move from cost reimbursement through global budgets to prospective reimbursement based on case

types redefines the unit of output in health care. Payment is no longer based on the individual service as the implied unit of output, but rather on the episode of care. The incentive to treat patients with resource-intensive, high-cost practice styles is thereby removed.

In the past, Ontario has experimented with a variety of hospital reimbursement techniques (Ontario Economic Council 1977); it currently employs 'prospective global budgeting' in which hospitals are expected to assume responsibility for any deficits they incur. The effectiveness of this approach remains to be seen. It will likely depend upon government's determination to refrain from picking up the tab for deficits in the future as it has in the past. Very limited experimentation is underway, however, with methods of prospective reimbursement based on case types (Horn 1983). The evaluation of this experiment and the analysis of the impact of its potential adoption across Ontario's hospital system appear to be important subjects for future research.

An important element of prospective reimbursement based on case types is the climate of cost consciousness it can create inside the hospital. The internal organization of hospitals has been characterized as a triangular tension between hospital administrators, physicians, and the board of trustees, all pursuing their own, often conflicting goals (Jacobs 1974; Harris 1977). Hospital payment methods that include binding incentives for efficiency may provide administrators with leverage for their attempts to rationalize utilization patterns, including preventing the indiscriminate use of both high and low technology.

Another development that warrants serious consideration for its potential to improve internal decision-making in hospitals is that of clinical budgeting (Wickings 1983), which has been tried in the United Kingdom. In these experiments, hospital clinical units and teams were given budgets with a well-developed framework of rules and incentives. Results indicate that these units and teams were able to work within the budgets and that savings were available for redeployment. Although clinical budgeting, like any other proposal, has its drawbacks, it appears to be one of the few methods available for making clinicians *inside* the hospital financially responsible for their decisions in managing patient care.[19]

Employing any of these developments in hospital-payment mechanisms would require extensive redesign of the data systems of

both ministries of health and individual hospitals. The nature of these refinements is itself a subject that will likely require further analysis.

Adjustments to the supply of physicians

Although an essential element of any overall plan, adjustments to the capacity of the health-care system will not by themselves rationalize patterns of delivery. A continuation of overall capacity restraints is essential, but the most important change required for future efficiency appears to be a change in the *mix* of types of providers and institutions.

The supply of physicians has been a constant source of concern in Canada since the early 1960s, although the nature of the concern has shifted considerably over time. At the beginning, the fear was that the stock of physicians would be insufficient to meet the increased demand expected to accompany the introduction of universal medical insurance. Consequently, medical schools were expanded and the immigration of physicians was encouraged. The result was a dramatic increase in the supply, continuing well into the 1970s, that exceeded both population growth and, in the opinion of most observers, the level required by population health needs. Recently, therefore, the concern has been that physicians are in oversupply.[20] As a result, measures have been taken to limit supply through a tighter immigration policy and through restrictions on medical-school enrolments and residency positions.

A continuation of these policies seems justified if expenditures on physician services are to be controlled. One of the most significant opportunities for improving the efficiency of medical-service delivery, however, is the full utilization of nurse practitioners. A large and conclusive body of research evidence has established that nurse practitioners are safe, effective, and acceptable to patients. Their potential for lowering health-care costs and expenditures (through their less expensive training and their effects on utilization patterns) has also been established in experimental situations.[21] The savings in health-care expenditures that would accrue from their full deployment has recently been estimated at about $300 million per year for Canada as a whole (Denton et al. 1983).

Like CHCs and HSOs, however, nurse practitioners have been used very little in Canada, often only in areas, such as the North, where

physician services are lacking. This is the result of a variety of factors including the current oversupply of physicians, existing legislation that restricts billing privileges and renders the employment of nurse practitioners unattractive to physicians in fee-for-service settings, and the deficiencies of past manpower 'planning' techniques (Lomas and Stoddart 1982a; 1982b). Obviously, the existing mix of personnel cannot be changed overnight; however, practical issues, such as the cost of introduction, the implications for medical education, and the removal of barriers to implementation, constitute important items on the agenda for research and planning.

Adjustments to institutional capacity

Past policies of global expenditure control and restrictions on the supply of hospital beds may well have squeezed some of the fat out of Canada's system of health-care institutions (Canada 1981). Ontario has certainly made significant strides during the past decade in limiting the numbers of acute-care beds and regionalizing expensive facilities. Yet, by international standards, the Canadian system still exhibits relatively high bed-to-population ratios and rates of hospital utilization. Although there does not appear to be any compelling reason to relax expenditure control and supply restriction policies, there does appear to be a need for adjustments to capacity for certain kinds of medical technology and for care of the elderly and chronically ill patients.

For medical technology, especially rapidly emerging high technology, the primary need is to ensure appropriate diffusion and utilization based on sound clinical and economic evaluation. The contrasting experiences of the United States (Banta 1980) and Sweden (Jonsson 1980) with the CAT scanner, for example, suggest that an extremely wide scope exists for the control of technology, with a correspondingly dramatic variance in its impact on health-care expenditures. The development of incentives, guidelines, or other mechanisms for the efficient application of innovative medical technology (as well as existing technology that is overutilized) represents another important agenda item for applied research in the health-care field.

As important, or perhaps even more so, are adjustments to the balance of institutional facilities. With the age distribution of the population changing and the morbidity being compressed into the

later years of life, there is an increasing need to reorient our acute-care system, which is now based on general hospitals. Although much has been done to raise the alarm about the future cost implications of this combination of circumstances, less has been done to specify carefully the appropriate balance of the various types of facilities, such as tertiary teaching and research centres, traditional acute-care hospitals, extended-care facilities, nursing homes, and patients' homes (see Boulet and Grenier 1978; Denton and Spencer 1983; and Bonham 1983). As one of the most detailed studies in this area (Gross and Schwenger 1981) illustrates, substantial rebalancing is required. Yet many important questions remain unanswered, including the exact extent of the inappropriate placement of patients in high-cost settings and accurate estimates of the cost structure for specific types of facilities along the spectrum, especially at the scale of operations that will be required in the future.

The mechanisms for accomplishing this rebalancing also remain unclear, given the understandable reluctance of established facilities to cede control and resources, the revenue constraints on provincial governments, and the presence of the private sector in the nursing-home portion of the spectrum. The appropriate mix of private and public financing and management and the mechanisms for implementing and monitoring it (a theme addressed more generally in the following section) are both unresolved issues.

POLICY APPROACHES TO MANAGING THE HEALTH-CARE SYSTEM

The goal of rationalizing health-care delivery, as Bird notes (Bird and Fraser 1981, 22), is the adequate, equitable, and efficient provision of health care in a federal system when government revenues are not increasing rapidly. The theme throughout this paper has been that the control of decisions affecting the production and utilization of health services must be linked with the responsibility for financing those decisions and services. Current policies of global expenditure-control and supply-restraint, although successful in containing costs in the short run, are not likely to improve efficiency significantly. Doing so will require additional mechanisms that affect practice style by altering input mixes (for technical efficiency) and the levels and types of services utilized (for allocative efficiency, judged against the standard of improved health).

Suggesting what needs to be done is, as usual, easier than providing a blueprint for how to do it. It does seem possible and useful, however, to categorize the broad policy approaches available and to point out aspects of certain policies that often do not receive enough attention.

The spectrum of available policies is sometimes stylized as running between increased regulation and increased competition.[22] The underlying issue that defines the spectrum, however, as noted by several commentators (particularly Williams 1978; Evans 1982; Bird in Bird and Fraser 1981), is the locus of control for production and utilization – who is to decide which services will be produced, by what means, where, and how often.

At one end of the spectrum is a system in which fully reprivatized financing accompanies private delivery of service. At the other end, direct public provision of services accompanies public financing. Both accomplish the linkage of financing to organization, though with very different effects. Both are also extremely unlikely in the Canadian political climate.[23]

However unlikely these scenarios, they do create a useful framework in which to make three observations on current policy alternatives.

'Increased treasury regulation' and 'increased consumer involvement'

First, attempting to move towards either end of the policy spectrum and failing might be worse than living with the status quo. In each direction are apparently appealing midpoints, which may be labelled 'increased treasury regulation' and 'increased consumer involvement'.[24]

'Increased treasury regulation' would involve more stringent controls on global expenditures (such as limits on the number of physicians allowed to bill the public plan, billing ceilings, hospital closures, and further cuts in medical schools' output) without any direct regulation of medical practice (such as restrictions on the frequency of billing for items on the fee schedule or adjustments to the relative fee structure to encourage alteration of utilization patterns). Although this policy approach might continue to contain expenditures, it would clearly make for increased confrontation in negotiations with providers, a costly process in itself. It would also accelerate the trend of patients' being caught in the middle of

disputes between providers and government. Perhaps most important, as the combination of rising unit costs and providers' income expectations reduced the real amount of services available within the expenditure limits, there would be no guarantee that the health-care needs of the population would continue to be met.

'Increased consumer involvement', on the other hand, would entail greater reliance on various forms of user charges, such as extra billing, co-insurance, or deductibles (with or without private insurance), without any significant changes to the current organization of health-care delivery. This policy approach, analysed in detail elsewhere by Barer, Evans, and Stoddart (1979), would control public expenditures, but it would also raise the combined total of public plus private expenditures.[25] In addition, because such an approach would violate the spirit, if not the letter, of existing health-insurance legislation, it would likely cause consumer dissatisfaction; if vigorously pursued, it would constitute a complete rethinking of the philosophy and commitment that have underlain the evolution of the existing health-care system.

Though initially appealing, both 'increased treasury regulation' and 'increased consumer involvement' fail to address the main deficiency of the status quo, financing without organization. The former explicitly avoids interference with patterns and styles of practice; the latter includes no mechanism by which consumers can benefit from their decisions or through which their decisions can signal providers to choose efficient practice styles. Neither of these policy approaches, therefore, appears likely to improve the value obtained from money spent on health care.

Publicly financed competition

A second observation on policy alternatives is that the scope for use of market forces *within* the umbrella of a publicly financed, publicly monitored health-care system may be more extensive than is currently believed. Elsewhere, I describe initial outlines for a system of publicly financed competition among three modalities of health-care delivery.[26] The key feature of such a system would be the simultaneous provision of incentives to providers and to consumers to select efficient practice styles, along with the integration of incentives for the efficient utilization of both medical and hospital services. Proposals such as these, which attempt to combine lessons

from the American HMO experience with the principles of medicare, are, however, embryonic and not without difficulties. A system of publicly financed competition would require significant changes to existing legislation – for example, that which guarantees patients 'free choice of provider' (even though these changes would appear to benefit patients). In addition, the operational feasibility of publicly financed competition has not received detailed consideration, and its likely effects on equity require further analysis. Nevertheless, the use of market forces within a publicly financed, universal health-insurance system appears to warrant further research on its feasibility and attractiveness as a new policy approach.

The need for long-term planning

A third and final observation on policy alternatives is that, even acknowledging the difficulties that will inevitably accompany any plan for rationalizing the health-care system, some long-term plan on the part of government is overdue. At the risk of unfairly characterizing past Ontario policies, one must say that a consistent set of policies embodying clearly defined, long-range goals has not been evident. In the management of an $8-billion enterprise with fragmented operating divisions, the need for clear policy goals and co-ordination is paramount. The health-care system will not remain static. Resources will be allocated by design or default. The important question is whether the consequences of those allocations are to be planned or unplanned.

CHANGE IN THE FEDERAL-PROVINCIAL ENVIRONMENT

Federal-provincial relations in general and the fiscal arrangements in particular remain an important factor in any provincial action aimed at rationalization of the health-care system. The efficiency implications of both past and existing federal-provincial fiscal arrangements are the subject of a separate discussion by Watson in this volume ('Health care and federalism') and so are not treated extensively here. It does, however, seem important to conclude with comments on two aspects of the federal-provincial environment – the continuing need for federal-provincial co-operation on matters other than fiscal arrangements and the possible implications of the Canada

Health Act for certain changes suggested in previous sections of this paper.

Aside from the need to resolve disagreements on fiscal arrangements, the continuation of federal-provincial co-operation is essential for dealing with influences on efficiency in health care that may be beyond the control of individual provinces. Perhaps the best examples are the need to co-ordinate immigration policy with the individual provinces' policies on the supply of physicians and the need for the provinces to have some forum in which to reach consensus on the subject. Federal-provincial co-operation is also essential in areas such as the development, assessment, and diffusion of medical technology and the funding of both basic medical research and research into the effectiveness and efficiency of specific health services and programs. In areas such as these, the benefits of investments accrue to all provinces, as well as to the international community.

As for the recently approved Canada Health Act, it would be unfair to criticize it for not dealing with some of the fundamental structural problems in the health-care system. This was not the purpose of the act. In fact, one could even argue that by giving the provinces incentives to eliminate user charges and extra billing, the act lessens the attractiveness of the 'increased-consumer-involvement' approach criticized in the preceding section.[27]

To the extent that the act reinforces existing organizational arrangements for delivering care, however, it may pose obstacles to some of the changes suggested here. For example, the parts of the act that deal with universality and accessibility appear to rule out the use of market forces within medicare through avenues such as publicly financed competition between alternative delivery modalities. These and other sections of the act will no doubt be the subject of debate, discussion, and conflicting interpretation for some time to come.

Finally, when people consider the act overall, it will be unfortunate if they perceive it as an endorsement of the current structure of the health-care delivery system rather than a confirmation of the goals and principles of medicare. Our health-care system is serving Canadians well, but it could be doing better.

NOTES

1 The simultaneous claims that we are spending both too much and too little on health care may be particularly disturbing to an economist observer, since the issue appears to be one of allocative efficiency, amenable to investigation, analysis, and resolution. In fact, as discussed later in the paper, the origins of the claims have little to do with issues of efficiency. Even if they did, the nature of the market for health services and its implications for consumer valuations of welfare make it unlikely that the disagreement could be resolved in a straightforward manner. This subject is discussed in more detail in later sections of this paper.

2 For a historical perspective on the development of the Canadian health-care system and a description of some early concerns regarding its organization and cost performance, see LeClair (1975).

3 This list of developments is not intended to be exhaustive. Several other items could be added, but these five seem most germane to the discussion that follows.

4 The importance of the 1977 change is still debated. As Soderstrom (1983) points out, well before the switch to block funding, the provinces had a strong incentive to control health-care spending and rationalize delivery systems in that they were spending much more than the famous 'fifty-cent dollars' at the margin. Before 1977, Ontario's marginal expenditure was \$0.82 for physicians' services (Soderstrom 1983) and \$0.66 for hospital services (Kapsalis 1982). All other provinces' marginal expenditures were higher.

5 This theme is not new. It has been recognized in commentary and reports on the Canadian health-care system almost since its inception. Most recently, it has been described by Evans (1981) and emphasized by Bird in Bird and Fraser (1981), the Parliamentary Task Force on Federal-Provincial Arrangements (Canada 1981), Evans (1982), and Lomas (1984). What is distressing, though explicable, is that so few attempts have been made to remedy the situation. Its persistence attests to the difficulty of making rapid or significant changes that affect the interests of established health-care providers and institutions.

6 All the data here are from a compilation by the Health Information Division of Health and Welfare Canada (Canada 1983). Total health-care expenditures as reported here refer to both public and private spending. A very interesting and detailed presentation of expenditure data for Ontario is available elsewhere (Ontario 1981); however, it covers only the period 1970/1 to 1977/8 and apparently has not been extended to the present.

7 For an assessment of the effects of several direct-charge schemes on public and private health-care expenditures, see Barer, Evans, and Stoddart (1979).

8 Evans also employs the income-expenditure identity to remind readers that total health-care expenditures can be seen either as the quantities of different types of care supplied multiplied by their average prices, or as the number of people drawing income of different types from health-care supply multiplied by their average incomes (1982, 392). Using this framework, the author provides a convincing analysis of the underfinancing-versus-overprovision debate. He concludes that although evidence of overprovision of services exists, the main reason for rejecting the underfinancing argument is that it is not motivated by the need to increase real utilization of services for improved health but by providers' dissatisfaction with their incomes.

9 In a recent study of the Ontario hospital experience from 1967 to 1981, Detsky, Stacey, and Bombardier (1983) reach a similar conclusion about reimbursement control, although they term it a 'regulatory strategy'.

Sole-source funding may not be an entirely accurate description of the Canadian system since approximately one-quarter of total health expenditures are in the

private sector; however, almost all expenditures in the 'institutions' and 'physicians' categories of Table 1 are publicly financed, and these two categories alone accounted for approximately 70 per cent of total health expenditures in 1982 (Canada 1983, tables 54 and 5). Any attempt to rationalize patterns of health-care delivery must, therefore, begin here.

10 See also Canada (1983, tables 3 and 13) for data indicating higher rates of growth in national health expenditures in the early 1980s than during the previous decade.

11 One of the most articulate presentations of this theme is in Cochrane (1972), but evidence can be found throughout the literature on health-services research. Other examples are Enthoven (1978), Abel-Smith (1976), and Fuchs (1974).

12 For development of and evidence on this theme see, among others, McKeown (1976), Canada (1974), and Hadley (1982).

13 For example, Arrow (1963), Culyer (1971), Kisch (1974), and most recently, Evans (1984) discuss the nature of health care and its implications for efficiency. As for other topics mentioned in this section, see, for example, Fuchs (1978), Evans (1974b), and Stoddart and Barer (1981) on the significance of agency in the utilization process; Enthoven (1980) and McClure (1978) on the economic impact of practice style; and Fuchs (1972), Culyer (1978), and Williams (1978) on concepts of need and health. (These references represent only a limited selection of the available literature.)

14 Both Bird (1981) and McClure (1978) explicitly note this point. The reconciliation of private and social welfare is particularly difficult for physicians. In their role as agent and advocate for individual patients, physicians further their own economic welfare whenever they 'do more' for their patients. This role as manager of episodes of care for individual patients (for which physicians' training prepares them) conflicts sharply with the expectation of the financers of care that the physician will act as a discerning gatekeeper to and manager of public resources. Fee-for-service reimbursement does nothing to encourage the execution of this second role.

15 One could undoubtedly identify other areas for change or sources of inefficiency (for example, within the pharmaceutical industry or in the provision of dental services); however, a focus on the matrix defined by the stated analytic themes and categories of expenditures seems more than justified, given the proportion of total health-care expenditures accounted for by physicians and institutions, the significance of physicians' decisions for other health-care expenditures, and the lack of incentives for efficient forms of organization and behaviour. Any attempts to rationalize the health-care system that do not address this matrix seem doomed to fail.

16 The incentives provided by all three methods are analysed by several authors (Glaser 1970; Abel-Smith 1976; Pauly 1970; Hornbrook 1983).

17 See Canada (1972) and Ontario (1982b) for descriptions of these organizations. Although the two models may differ significantly in payment methods and the locus of control for decisions on the production of services (Stoddart 1983), the distinction is often blurred and, in Ontario, the terms are often employed interchangeably (Ontario 1982b, appendix A).

18 See Migue and Belanger (1974) and Barer (1981; 1982) for a Canadian overview. More widely known perhaps is similar work on diagnosis-related groups (DRGs), which Horn (1983) discusses in a Canadian context. New hospital-reimbursement systems based on diagnosis-related groups have already been adopted in parts of the United States. For commentary on both their potential and their pitfalls, see, for example, Davies and Westfall (1983) and Gonnella, Hornbrook, and Louis (1984).

19 Wickings' (1983) listing of the characteristics of successful cost-control systems may be of more than passing interest to those attempting to rationalize health-care

delivery in Canada. He suggests that they must (1) be prospective, (2) allow parties to gain some powers that they did not previously have, (3) allow parties to continue to make their own ethical, professional, or economic judgements, (4) allow parties to mount effective resistance, and (5) provide parties with some incentive to improve both short- and long-term cost-effectiveness.

20 By necessity, this passage is an oversimplification of a complex issue. Given the caveats raised above, it is extremely difficult to determine shortages or surpluses of physicians through either a technical or an economic approach. Moreover, throughout the periods during which popular wisdom has held that either shortages or surpluses existed, physicians' services have been geographically maldistributed. For discussion on these topics, see Evans (1976), Brown (1977), and Roos, Gaumont, and Horne (1976).

21 Results from the randomized trial of nurse practitioners in Burlington, Ontario are internationally known. See Spitzer (1978) for a summary. Record (1981) provides a comprehensive treatment of the subject in the U.S. context. Bibliographies of other evidence can be found in recent articles by Lomas and Stoddart (1982b) and Denton et al. (1983).

22 See, for example, McClure (1978) and Stoddart (1983). The dichotomy is, however, an oversimplification, since a move in either direction will not remove the need for or the presence of elements from the other (Evans 1982).

23 Paths for reform of the Canadian health-care system are discussed by Blomqvist (1979), Bird in Bird and Fraser (1981), and Evans (1982). The latter two authors, unlike Blomqvist, believe that more, rather than less, public involvement is required, and that it is the direction Canada will pursue. Evans also describes the 'private' end of the spectrum, pointing out that 'there is no experience, anywhere, with a fully privatized, unregulated health care system' (1982, 390). McLachlan and Maynard (1982) offer a thorough treatment of the alternative mixes of public/private choice found internationally.

24 These midpoints are developed and analysed in more detail by Lomas and Stoddart (1982d).

25 User charges have been extensively debated and researched in the literature on health economics. For an overview, see Badgely and Smith (1979). The analysis in Barer, Evans, and Stoddart (1979) examines the effects of many of the commonly proposed schemes on the policy objectives of risk reduction, wealth transfer, and both technical and allocative efficiency (see chapter 6 and especially table 2 for a summary). The general conclusion is that unless incentives to consumers are accompanied by appropriate organizational changes in the supply of services, there is little basis on any of these grounds for increased 'patient participation' in financing. This conclusion is also consistent with Bird's argument in Bird and Fraser (1981). However, other views exist on the subject; see, for example, Fraser in Bird and Fraser (1981).

26 The skeleton of such a system, with its anticipated advantages and difficulties as well as unanswered questions about it, is presented in Stoddart (1983). A slightly revised presentation is in Stoddart and Seldon (1984). Initial reactions to and criticism of the proposal can be found in the discussion following this paper. Lomas and Stoddart (1982c) outline a similar system, though one with a different treatment of the hospital sector.

27 This line of argument should not be pursued too strenuously. Both Manga (1984) and Soderstrom (1983) discuss circumstances under which provinces may find it desirable and even economically advantageous to allow these practices to continue. Furthermore, my comments here are not intended to be a thorough assessment of the efficiency implications of the Canada Health Act. Space precludes discussion of several other important issues, such as the exclusion of private insurance.

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Health care and federalism

William G. Watson

For close to three decades, conditional grants from the federal government to the provinces have played an important role in the financing of health care in Canada.[1] The introduction of the Canada Health Act into the House of Commons in December 1983 brought the perennial question of the federal government's appropriate role in the health-care sector back into the political limelight. The purpose of this paper is to see whether received economic theories of intergovernmental grants can justify or explain this role.

The paper is in three sections. The first reviews the normative arguments for both intergovernmental grants and the public provision of health care. It concludes that although there are several reasons for public provision of health care, none seems to require the participation of the federal government in its finance. Similarly, although there are several possible rationales for general intergovernmental grants, none appears to justify conditional grants for the provision of health care. The paper's second section asks whether a 'public-choice' approach to the positive theory of public expenditure can help explain the evolution of Canada's present system of financing health care. The answer appears to be yes, although at one or two points in the system's history, the positions of the federal and provincial governments were somewhat different from what the usual hypotheses about motivation would have predicted. The third and final section of the paper consists of a sum-

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mary as well as a brief commentary on the Canada Health Act *vis-à-vis* the theory of federalism.

JUSTIFICATIONS FOR FEDERAL GRANTS

Reasons for the public provision of health care

This section of the paper reviews several well-known justifications for public participation in the supply of health care (see Arrow 1963; Pauly 1971). They range from market failures resulting from externalities in the consumption of health care or from information shortages in health insurance to justifications based on rather particular notions of what constitutes social equity. The section's main message, however, is that although there are many reasons to suppose the public supply of health care will be necessary, few of the standard arguments have much to say about which level of government should either finance or deliver it.

Externality and disease

Perhaps the most obvious rationale for publicly provided health services involves the externality caused by contagious diseases. Private individuals generally underinvest in measures that would reduce the chance of other people's catching such diseases; therefore, government may have a role in subsidizing public-health measures. Similarly, provincial governments are likely to discount the extraprovincial benefits of their own spending on health care and are therefore likely to underinvest in preventive measures. For the externality to be fully internalized (in the absence of spontaneous negotiations between provinces), allocation decisions must be taken by a jurisdiction whose boundaries encompass the full effects of the externality. Thus, the federal government can supply health services itself, or, if for some reason such services are to be funded locally, it can provide the provinces with conditional grants in an amount sufficient to stimulate efficient supply.[2]

Although this externality argument does not justify conditional grants for health services whose benefits are essentially private, the current Canadian system involves federal finance for a wide range of health services, only a few of which are likely to reduce the spread of contagious disease. Note also that a federal subsidy aimed at solving this externality problem must change the relative price of health care

to the provincial governments. Yet even before Ottawa moved to block-funding of health-care programs in 1977, its grants caused only a slight change in the relative price of health services:[3] with block-funding, of course, there is no change in relative price.

Moral hazard and adverse selection

A second standard argument for government funding of health care is that the market for health insurance is subject to problems of moral hazard and adverse selection. As Arrow (1963) argues, many states of ill health are probably avoidable; given a system that reduces the patient's cost of treatment, preventive measures will likely be undersupplied and patients will overconsume care for those diseases they do contract. He also points out the problem of adverse selection: if insurance companies cannot discriminate among customers, they may get a bad draw; if they can discriminate, they will provide chronically ill people with insurance only at prohibitive premiums. Clearly, this problem is essentially one of distribution.

Although Arrow raises his difficulties mainly to explain the emergence of idiosyncracies of the market for medical care, many subsequent observers cite the possibility of market failure in health insurance as a justification for the public supply of health care. This does not necessarily follow. If the problem is that people do not engage in sufficient prevention, the state can support preventive measures directly. Similarly, if the private undersupply of insurance is thought to have unfavourable distributional consequences, government can establish public programs for the truly deserving, even at the expense of including those whose diseases could be avoided. On the other hand, the idea that the market for health insurance simply will not exist is unreasonable. Before the introduction of federal medicare, the majority of the Canadian population were either covered by some health insurance or belonged to prepaid health-care programs (see Shillington 1972).[4]

Once it has been decided to establish a public program, however, the question of the appropriate jurisdiction arises. If the public-insurance program is to aim at the diversification of risk (which it should, since the inability of private plans to do this is an important rationale for its existence, and if, as seems likely, the amount of diversification accomplished is more or less directly related to the size of the population covered, there may be a minimum efficient scale

for public plans. Some Canadian provinces may simply be too small to accomplish the desired amount of diversification. However, this is less an argument for compensatory federal grants than for direct federal participation in health care or, indeed, for the amalgamation of several provinces' plans into regional plans.

The same can be said of arguments involving economies of scale of one sort or another in the administration of health insurance.[5] Such economies may justify direct federal intervention in supply, but they justify *conditional* federal grants only if the condition is that the provinces amalgamate their administrative apparatus.[6]

The merit-good argument

A final efficiency argument favouring public intervention in the health-care sector is the merit-good argument – the last refuge of the interventionist – according to which people simply undervalue the benefits they themselves receive from health care and should, therefore, be induced by a more prescient government to purchase more of it. Of course, to justify federal conditional grants on these grounds, it must also be supposed that the preferences of federal policymakers are superior to those of provincial policymakers. Except where extraprovincial spillovers exist – and this case has been discussed already – this argument is hard to credit.

Redistribution of income

Most other rationales for the public supply of medical services involve the fairness of the income distribution. Although the usual argument is that redistribution in cash works best, the literature does contain some examples in which redistribution in kind is preferred. Tobin (1970) argues, for instance, that voucher systems in medical care would serve mainly to increase the incomes of doctors (whose supply is virtually fixed in the short run and probably not very elastic in the long run). In the absence of general redistributive measures, such as a negative income tax, the public supply of medical services may be a reasonable way of ensuring that the benefits of public dollars spent on health care actually do go to those for whom they are intended.

Once it has been decided to supply health care in the public sector, however, such arguments seem to provide no particular justification for choosing between federal and provincial finance of the program.

A rent is a rent is a rent, and it can make little difference whether the dollar that creates this rent comes from the federal or the provincial treasury.

On a related point, Arrow observes that taxpayers are often reluctant to engage in unconditional redistribution: 'the taste for improving the health of others appears to be stronger than for improving other aspects of their welfare' (1963, 27). Pauly (1971) formalizes this approach by arguing that some people's – mainly the poor's – consumption of medical care enters directly into other citizens' utility functions. This externality in consumption creates the presumption that medical care will be underfunded if left to the private market. It follows that if the consumption externality extends beyond provincial boundaries, there is a potential role for federal transfers to the provinces. Thus, one possible rationale for the current system of grants is that all Canadians consider themselves affected by even the essentially private health-care consumption of all other Canadians.[7]

The main difficulty with this argument is that it is *ad hoc* in the extreme. Why does it hold for health care and not for food? or clothing? or shelter? or even primary education? Why use it to justify intervention in providing all forms of health care, rather than simply insurance against catastrophe? And why is it necessary to subsidize the health care of every citizen in a province, rather than simply the poor? On the other hand, although 'specific egalitarianism' of this sort does not sit well in logic or in the literature (Tobin 1970), casual empiricism suggests donors do believe malfeasance will be greater when transfers are made in cash. From this perspective, however, a crucial difficulty with the post-1977 system of federal grants is that it offers no guarantee the provinces will spend the funds on health care – which is what is wanted if the problem truly is one of externalities.[8] As matters now stand, federal transfers represent between 40 and 50 per cent of the total amount spent on health care; it is hard to imagine that closing the utility gap created by the existence of out-of-province benefits requires an expenditure this large. From this viewpoint, it is also hard to justify the federal government's extreme reaction to the introduction of extra billing in several provinces.

Moreover, the Canadian Constitution presents several obvious difficulties for this argument. Specific egalitarianism presumably

requires that all Canadians have access to the same amount and kinds of health services. Yet, mainly as a result of historical accident, health care falls within provincial jurisdiction. It obviously is not easy, perhaps not even possible, to reconcile local control over health services with the notion that all Canadians should have the same access to health care. But here the economist's instinct to remedy externalities must give way to the constitutional lawyer's desire to demarcate clear areas of responsibility.[9]

Reasons for federal grants to the provinces

The literature also contains several justifications for grants from federal to provincial governments. Among them are the existence of spillover benefits from public consumption within a jurisdiction, the possibility that provinces will not have enough revenues to fulfil their expenditure obligations, and, finally, the need to assure fiscal equity and discourage inefficient interprovincial migration. But, as this section tries to demonstrate, none of these general arguments favouring grants justifies the massive transfers the federal government currently makes to finance provincial health-care programs.

Interprovincial spillover

The existence of spillovers from provincial programs of one sort or another is also one of the classic rationales for federal grants to the provinces.[10] In the case of health care, as already noted, the spillover can be direct and tangible – if, for example, germs, viruses, and the like are prevented by public-health measures from crossing provincial boundaries. Or it can be indirect – if, say, citizens are happy to see their compatriots in other provinces consuming medical services, even if this has no effect on their own health. As suggested, however, it seems unlikely that the externality argument can justify either the current extent of federal grants or the recent federal attempt to outlaw extra billing.

Fiscal co-ordination

A second general argument for federal transfers to the provinces is that running several tax systems in a single country may well entail significant efficiency costs. Of course, efficiency can also be had by

close co-ordination of provincial tax policies. Moreover, even if it should be decided that having the federal government collect taxes and distribute the revenues to the provinces is the least-cost route, there is no reason for such grants to be conditional.

Fiscal gap

Similar reasoning applies to the 'fiscal gap' argument. It is often claimed that the Constitution Act of 1867 and its subsequent interpretation in the courts has left the provinces with most of the more burdensome financial responsibilities in Confederation and few of the most lucrative financial resources. This argument does not ring true, however. In fact, successive judgements have given both levels of government access to most tax bases.

Of course, the provinces' *customary* share of the revenues produced by these bases may fall short of their perceived responsibilities for expenditure. The obvious remedy here is for governments that do not especially need the revenues to cede access to governments that do, and, in fact, in the mid-1960s the federal government was eager to have the provinces occupy a larger proportion of the personal-income-tax field. But even if policymakers today decide to close the 'fiscal gap' not by ceding tax shares but by providing grants, then these grants clearly should be unconditional. Conditional grants imply a provincial deficiency of funds in relation to the federal government's view of provincial expenditure needs, but in most areas the intent of the Constitution is to have the provinces determine their own needs.

Fiscal equity

A good deal of attention has been paid recently to the argument that federal grants are necessary to achieve fiscal equity. One problem with achieving horizontal equity in a federal state is that people at the same given 'pre-fisc' standard of living are generally left with different 'post-fisc' standards of living if they live in different provinces.[11] Suppose Y_i is the pre-fisc income of a person in province i; then

$$Y_i + (B_i - T_i) + (B - tY_i)$$

is his or her post-fisc income, where B_i is the dollar value of the benefits the person receives as a result of provincial government spending; T_i is the amount he or she pays in provincial taxes; B is the benefit from federal expenditures, which is assumed to be the same *per capita* across the country; and tY_i is federal taxes paid, where t is the federal tax rate.

In a federal system, the value of this expression may vary from province to province even for people who have the same pre-fisc incomes. To establish strict horizontal equity, this difference in post-fisc incomes must be eliminated.[12] This can be done either with a system of federal equalization grants or with a net equalization scheme in which provinces with higher-than-average revenue bases transfer funds to provinces with smaller-than-average bases. Of course, an equalization system that provided a complete offset to differences in post-fisc incomes across provinces would mean that provinces could not engage in independent schemes of income redistribution, a situation that would run afoul of Canadian constitutional practice.[13] Also, however citizens fare personally under redistribution, they may have varying preferences about how much redistribution their provincial government should undertake. Thus, although interprovincial differences in fiscal residua may offend some notions of horizontal equity, so long as people are free to move from province to province such differences may well fit into a larger scheme of allocating people with different redistributional preferences across provinces.

Some of these points can be formalized (slightly) to highlight the argument that has been made so far. Between any two provinces, i and j, where $Yi = Yj$, horizontal equity requires that

$$Y_i + (B_i - T_i) + (B - tY_i) = Y_j + (B_j - T_j) + (B - tY_j),$$

or

$$(B_i - T_i) = (B_j - T_j).$$

Thus, when the fiscal residuum is less in i than in j, the federal transfer to individuals in i should be

$$(B_j - T_j) - (B_i - T_i).$$

Call this value E^*.

Of course, a second way in which perfect horizontal equity could be achieved would be to do away with provincial programs entirely. In this case, equity would be a trivial matter; whenever $Y_i = Y_j$,

$$Y_i + (B + tY_i) = Y_j + (B + tY_j).$$

In fact, the current Canadian equalization scheme falls considerably short of eliminating fiscally induced differences in income across provinces. Thus, the question that is important for present purposes is this: what happens to horizontal equity if, in a federal state in which actual equalization falls short of E^*, responsibility for at least part of the finance of provincially provided medical care is transferred to the federal government? Although one's first response might be that greater federal participation will inevitably reduce differences in fiscal residua, a moment's reflection suggests that this is not necessarily the case. The transfer will cause the same increase in federal taxes for two individuals in different provinces and, if the federal budget is to be balanced, the same reduction in their federal benefits. But the effect on the provincial fiscal residua depends on how the respective provinces spend their marginal federal dollars. Enlarging the federal role may even increase the difference in fiscal residua. Suppose, for instance, that the only fiscal difference between two provinces were in the redistributive impact of their health-care expenditures. Inducing further expenditures on health care might well increase this difference.

What seems more likely, however, is that a transfer of responsibility will have little effect on fiscal residua. Suppose the provinces respond to the grants by making equivalent increases in all citizens' fiscal residua. Different increases in different provinces will result only if some provinces get larger net grants from the federal government. All that this analysis shows, however, is that to the extent that federal conditional transfers contain an element of equalization, they will have an effect equivalent to that produced by equalization payments – a result wholly uninteresting to the policymaker. If the federal government wishes to get equalization-like effects, the way to do it is to increase the equalization payments,

not to set up extremely expensive, conditional-grant programs that have only a small equalizing effect.

Discouraging inefficient interprovincial migration

The same comments apply to the increasingly common argument that federal transfers to the provinces may be necessary in order to prevent inefficient migration within a federation.[14] People with the same pre-fisc incomes in any two provinces will have the same post-fisc incomes if the central government undertakes all expenditures and taxation or if some form of equalization program entirely eliminates interprovincial differences in fiscal residua. But if those people do not end up with the same post-fisc incomes, they have an incentive to move. Since their pre-fisc incomes are the same in the two provinces, their moving consumes resources without adding to national output and is, therefore, inefficient.

Yet again it is difficult to predict what effect shifting closer to a centralized system has on interprovincial differences in fiscal residua. If the principal differences among provinces lie in their unequal access to 'source-based' taxes (see Boadway and Flatters 1982) – an increasingly common assumption in the Canadian literature on this subject – grants under the established programs financing arrangements can have little effect on fiscal residua. The reason, in heuristic terms, is that it is hard to offset Alberta's resource revenues by making what are essentially equal per capita grants to all provinces, including Alberta.

A final justification for intergovernmental grants arises from the possibility that when provincial governments provide public goods, people who leave one province and enter another create fiscal externalities that they did not take into account in making their decisions to move. One possible remedy for this externality is to impose exit and entry taxes that reflect the losses to others created by moves. Another is to subsidize the citizens of underpopulated provinces to give them an incentive to not undertake inefficient moves. But again, in the absence of appropriate taxes or subsidies, federal finance of a portion of provincial expenditures is not likely to constitute a useful second-best policy.

Thus, it seems reasonable to conclude that the standard justifications

for federal grants to the provinces do not provide convincing support for the argument that health care should be funded federally.

EXPLANATIONS FOR THE CURRENT SYSTEM

In view of this lack of an overriding theoretical presumption in favour of Canada's present financing of health care, it is worth asking why the system has developed.

The positive theory of public expenditures has come to be dominated in recent years by the 'public-choice' school, which holds in brief that political decisions usually result from the self-interested behaviour of public officials – politicians and bureaucrats alike. Thus, a public-choice analysis of federal grants to the provinces might have it that given the constitutionally specified 'assets' of the two levels of government (see Watson 1982), it serves the interests of the officials of both to have the federal government raise taxes to finance provincial health-care programs. In fact, the standard explanation for the existence of federal grants to the provinces is that Ottawa can get greater political mileage by retaining its tax powers and helping to fund worthy provincial programs than it could by simply reducing federal taxes and allowing the provinces to take over full responsibility for health-care services. In brief, the benefits the program offers are appreciated more than the taxes required to finance it are resented.[15]

What is less easy to explain is why the provinces acquiesce in this arrangement. If the federal government judges that there are net pay-offs from raising taxes to fund health care, provincial politicians presumably feel the same way and would, therefore, prefer to exercise exclusive jurisdiction over health care.[16] Of course, by emphasizing the nationally egalitarian nature of the program, the federal government may be able to extract political benefits from it that are unavailable to the provinces (since, by definition, no province can establish nationwide equity). It is also true that the low-income provinces do better financially under what amounts to a system of per capita grants than they would if equivalent tax points were transferred to them. But separate arrangements could easily be devised to compensate these provinces for their fiscal deficiencies.[17]

Still, the fact remains that responsibility for health care falls squarely in the provincial jurisdiction. Moreover, the provinces have just as much right to levy income taxes – the principal source of

federal revenues and, therefore, of federal grants – as the federal government has. Thus, the present arrangements seem largely an historical accident. At the end of the Second World War, the federal government controlled the personal and corporate income taxes and, because it had a lengthy policy agenda, was reluctant to abandon them. An extremely loose coalition of provinces was unable to bring enough pressure to bear to end the stand-off inherent in joint occupancy of a single tax field. Since the clear demarcation of constitutional prerogatives prevented the federal government from establishing its own programs in many of the social services, a system of conditional grants was born.

In fact, this potted version of history is probably not far from the truth. The story has one or two complications, however. For instance, medicare, one of the largest of the cost-shared programs, was introduced by Lester Pearson's government, which – in its first two years, at least – set great store by a co-operative federalism whose nuts and bolts were the phased transfer of tax points to the provinces and the eventual elimination of cost-shared programs. At the federal-provincial conferences of 1963 and 1964, the federal and several provincial governments argued quite explicitly that the purpose of the relatively new equalization program was to provide the provinces with the financial wherewithal that would allow the federal government to withdraw fully from their jurisdictions.[18] The federal government followed up on its rhetoric by pledging to extend the equalization formula both to cover tax revenues from all provincial sources and to provide equalization to the average of the two wealthiest provinces, rather than to the average of all the provinces. Moreover, the idea that the ten provinces would inevitably be outmanoeuvred by a single federal bargaining unit was proved wrong by Ottawa's swift surrender on the Quebec Pension Plan, an instance of submissive federalism that cost the federal government several points off the personal income tax in a matter of days (see Simeon 1971). Though Quebec's position on intergovernmental fiscal matters did not always reflect those of the other provinces, its aggressive bargaining generally did result in all provinces' at least having the option of picking up additional tax points.

Although it is not easy to reconcile the Pearson government's demonstrated willingness to abandon cost-shared programs with its

eventual introduction of medicare, the simplest explanation is probably also the best: when medicare came into conflict with the government's view of intergovernmental relations, co-operative federalism simply lost out to the leading Liberals' reformist tendencies. Popular accounts of the times indicate that the new government felt itself fully committed to medicare (see Newman 1968; LaMarsh 1969). A national health-insurance program had been a plank in the Liberal platform for twenty years (although being part of the platform obviously does not guarantee that a policy will be adopted). The views of Walter Gordon and Tom Kent, which had dominated the party's policy since the late 1950s, were obviously well disposed to medicare.[19] Moreover, the report of the Hall Commission (Royal Commission on Health Services 1964) had brought the question of national health insurance centre stage.

What is perhaps more surprising than the fact that the Pearson government opted for social reform over co-operative federalism is that the provinces acquiesced so readily in the introduction of medicare. Of course, when the federal government offered to finance what was undeniably a popular program – in fact, a program that several provincial governments had already pledged to bring in on their own – it was difficult for the provinces to resist in a politically credible way. Moreover, unlike, say, the Canada Pension Plan, medicare was not a federal program, but a federal promise to provide grants to provincial programs that satisfied what were advertised at the time as minimal requirements. By the time it became clear that the requirements might be more restrictive than had been anticipated, the commitments to join the plan had already been made.

CONCLUSIONS

The upshot of the discussion presented in the first section above was that it is hard to find an efficiency rationale for conditional grants to the provinces for the purposes of providing health care. There *are* externalities in health care, though probably none so large as to justify a subsidy of roughly 50 per cent. Moreover, any externalities that may exist justify only grants that change the relative prices of health care to the provinces, not block grants. Nor do the grants attempt to offset differences in fiscal residua across provinces. Apart from the federal government's obvious interest in preventing

unnecessary barriers to interprovincial mobility, there is no obvious reason why it should play an important role in this area. Even those arguments that have the federal government engaging in specific egalitarianism are significantly flawed. Most provincial governments probably would spend a large portion of untied federal grants on health care: provincial politicians cannot afford unfavourable comparisons with their counterparts in neighbouring provinces.[20] And even if provincial officials would not make such spending decisions, it is hard to see why the federal government's redistributional preferences should take precedence over those of duly elected provincial governments.

On the other hand, it *is* possible to understand why a system of conditional grants came into existence in the first place and why, once having been established, it has persisted. A purely positive analysis of the current regime suggests, moreover, that conditionality is likely to be with us for some time yet. The Canada Health Act has re-established a measure of the conditionality that existed before 1977.[21] It will be difficult politically for Ottawa to retreat from this position, for each of the three federal parties has endorsed the principles of the act.

On normative grounds, this situation probably is unfortunate. Assuming that public revenues continue to be constrained, as the demographics of health care become increasingly unfavourable, the need for price rationing in the health-care sector is likely to become more, not less, acute. Yet the federal government's stand on extra billing and user charges effectively prohibits the provinces from using price rationing. Given what appears to be strong public support for income redistribution via the public provision of health care, it would probably be possible to devise pricing schemes that did not exclude the poor from access to health care. (The provincial governments that have expressed the desire to experiment with pricing of health services have, in fact, said they intend to shield the poor from the ill effects of these increases.) Though protecting the access of the poor might well require means testing of one sort or another, the original federal criteria made no stipulations about how accessibility would be guaranteed.[22]

In sum, the federal-provincial debate over health care appears to be yet another case in which economic theory has had much less influence on events than realpolitik. Moreover, ideological

considerations, whose influence economists usually discount, seem to have had an important role in shaping events.

NOTES

1 Before 1977, the grants were open ended and explicitly conditional. After 1977, they were closed but still conditional in that the federal government required the provinces to adhere to the five underlying principles of medicare enunciated in the original act. Many analysts see recent federal initiatives as an attempt to increase the conditionality of the health-care side of the Established Programs Financing Act.

2 In fact, federal grants to the provinces to support public-health programs date from as early as 1919 (see Boadway 1980).

3 Before 1977, a province's medicare grant was equal to one-half the national average of per capita expenditures on medical care times its population. Thus, the federal grant changed the relative price to the province only insofar as that province's expenditures changed the national average; for many provinces that change was not very large. Under the Hospital Insurance program, the grant was one-quarter of the national average expenditure plus one-quarter of the province's own expenditure.

4 Ironically, prepaid programs are now thought by many to offer a solution to the problem of cost inflation in the health sector (see Watson 1984).

5 Arrow (1963) argues that private-insurance regimes may involve wasteful duplications of administrative costs or excessive investment in persuasive advertising. While this hypothesis suggests that monopoly supply may be preferable, it says nothing about which level of government is best suited to supplying health care.

6 In fact, at one federal-provincial conference, Quebec complained:

> The existence of . . . joint programmes signifies a loss of efficiency or work duplication and higher administrative costs. The provinces must have a staff whose specific task is to give accounts to Ottawa on the manner these programmes are carried out. The federal government must, in turn, employ officials to make sure that the conditions which it has stipulated have been respected by the provinces. (Canada 1968a)

Several other provinces have voiced similar objections from time to time.

7 As Prime Minister Lester Pearson said, introducing the original federal proposals:

> I believe that Canadian attitudes and Canadian economic standards have now developed to the point at which we are ready to regard medicare as part of Canada's basic social standards. . . . If a certain standard of public medical services is needed and approved by Canadians generally, appropriate fiscal resources have to be brought into play on a national scale in order to make the services available to a national standard in all parts of the country. (Canada 1968c, 16)

8 On the other hand, the federal government has shown no reluctance in the past to cite horizontal equity as the main justification for unconditional grants, which carry no stipulation at all that the benefits they make possible not be passed on in the form of tax relief.

9 See Usher (1980) for a convincing argument that clear demarcation of jurisdictions is probably desirable. Some observers would have it that a federal intervention in the presumptively provincial domain is justified by a model in which different levels of government compete with one another to provide services to citizens. This

interpretation clearly begs the question of why exclusive jurisdictions exist in the first place. Allowing a free-for-all on all matters of jurisdiction would presumably waste large amounts of resources.

10 For elaborations of the arguments presented in this section, see Boadway (1980) or Break (1980).

11 A person's pre-fisc income is his or her income before governments have either taxed away some of it or added to it by providing transfers or public services.

12 Eliminating the difference in post-fisc incomes is what Boadway and Flatters (1982) call 'broad-based' equity.

13 Not surprisingly, the Constitution is silent on the question of redistribution. Still, the provinces have been given jurisdiction over so many expenditure programs whose modern-day purpose is redistribution that it seems inconceivable that they should not be deemed free to go their own ways on redistribution.

14 Academics concerned with the link (if any) between academic research and economic policymaking will be interested to learn that at the November 1963 federal-provincial conference on intergovernmental fiscal relations, Premier Walter Shaw of Prince Edward Island quoted extensively from James Buchanan's paper (1950) on fiscal equity. It is not clear, however, what effect the premier's intervention had on subsequent events.

15 Of course, the pay-off in political visibility from supporting health care accrues yearly while the reduction in federal taxes that would be made possible by federal withdrawal from the field would occur only once.

16 Quebec, of course, retains such exclusive jurisdiction, presumably because it finds advantage in doing so. It might be thought that at the margin, where provincial governments decide to cease funding medicare, there is still a net political pay-off to the federal government on the grounds that it will not yet have gained any benefit from association with the medicare program. But this suggests that citizens attribute different values to identical packages of taxes and expenditures depending on which level of government provides them, which surely constitutes 'jurisdiction illusion'.

17 During the mid-1960s, both Premier Walter Shaw of Prince Edward Island and Premier Louis Robichaud of New Brunswick proposed that the federal share in cost-shared programs vary according to provincial fiscal capacity (see Canada 1968a; 1968b; 1968c).

18 Prime Minister Pearson put it as follows:

> The underlying reason for our discussion is the growing belief that, provided there is adequate equalization, services provided by the provinces should be paid for by taxes which the provinces raise. I do not think anyone quarrels with that principle. Certainly the federal government does not. (Canada 1968a, 10)

19 The essentially ideological nature of the debate on medicare within the Liberal Party is indicated by the fact that after Gordon's resignation from cabinet, Mitchell Sharp, as the new finance minister, was able to secure approval for a one-year delay in its introduction from the 1966 party-policy convention. Sharp's rearguard action against medicare was so successful that there even appears to have been doubt about the plan's eventual introduction until shortly after the April 1968 leadership convention, when the new leader – whom Judy LaMarsh, for one, characterized as a small-L liberal – confirmed that the plan would go ahead, as scheduled, on 1 July 1968.

20 The fact that the introduction of the hospital-insurance and medicare programs did not take place until the federal government's initiatives in the late 1950s and mid-

1960s does not give a true indication of the provincial preferences of those days, let alone these. Provincial access to income-tax revenues was very limited during that era, and it therefore would have been fiscally irresponsible for provinces to introduce free, universal health-care programs.

21 Many people have argued that the Canada Health Act makes medicare even more conditional than it was in the 1960s. This is probably not true. The negotiations that led to successive entrance of provinces into the national plan involved considerable intervention by the federal government in the design of provincial arrangements (see Shillington 1972). Moreover, when the federal government calculated the grants owing to each province, revenues generated by the user charges that several provinces maintained during the first years of the program were subtracted from eligible expendiures (see Belanger and Migue 1974). Though admittedly less than Monique Begin's dollar-for-dollar tax, this was, nonetheless, a tax.

22 In introducing the federal proposals, Prime Minister Pearson declared :

> How a Province raises the rest of the cost, over and above premiums, if any, is entirely a matter for provincial decision. Co-insurance or other deterrent charges are not favoured by the federal government but they are not ruled out by the principles we propose, *provided* that they are not of such a size as to violate the principle of universality by effectively denying service to low-income people. (Canada 1968c, 92; emphasis in original)

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Comments
G.W.S. Scott

I am honoured to have the opportunity to comment on the work of both Greg Stoddart and William Watson in addressing health care in the 1990s. Just a few months ago I was struggling with the problems with health care in the 1980s, and I cannot begin to tell you how much relief I feel in jumping ahead a decade.

The perspective in which Professor Watson placed federal-provincial relations provided, for me at least, a change of pace. I must admit, however, that my commentary picks up with the last paragraph of his paper: 'Economic theory has had much less influence on events than realpolitik. Moreover, ideological considerations, whose influence economists usually discount, seem to have had an important role in shaping events.' To that I say amen! And I suggest that the validity of his proposition is most relevant to the policy issues that lie ahead.

Those issues are significant to the lifestyles and practice patterns of people in the system. Ideological complications, too, will provide no less a barrier in the future than in the past to the application of economic theory and rational, cost-effective reforms.

The Canada Health Act

The most recent manifestation of Professor Watson's proposition is the Canada Health Act, which the federal government billed as a review and a consolidation of our health-care policies, as an initiative that would preserve medicare. Today we have on our books legislation that is a federal ideological response to some minor problems in the system and that completely ignores the real health-

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care and financial issues that will, if not readily addressed, eventually threaten the world's most successful health-care system.

I must here take issue with Professor Stoddart's contention, 'It would be unfair to criticize [the Canada Health Act] for not dealing with some of the fundamental structural problems in the health-care system.' The whole legislative process was sold to the public as the effective response to an endangered health-care system. The federal government not only implied that the act was all that was needed; it absolutely refused to discuss related issues, such as finance.

So when Professor Stoddart states, 'when people consider the act overall, it will be unfortunate if they perceive it as an endorsement of the current structure of the health-care delivery system', he is whistling in the wind. That is not only how the act was sold – it is precisely the effect of the act. It locks in all the 1960s' biases for more doctors and more institutions, and its emphasis suggests that the answers to our health-care problems lie in institutionalized, high-technology responses. The very trends that Professor Stoddart advocates are shunned by the tone and direction of the legislation. Whatever the private opinions of the federal politicians and officials reponsible, they gave no sign that they would welcome system reform, with its financial and political complications, for some time to come.

The current health-care system

Before examining the rationalization of the system that Professor Stoddart has proposed, I want to underline some of his observations on the current cost of health care to Canadians.

We do very well in health care compared to citizens of other countries. Its quality is excellent, and until recently we have been relatively successful in holding its costs to a reasonably stable percentage of GNP. Nonetheless, our problems with the current system are growing, and we must be prepared to tackle them quickly if we realistically expect to contain them. To put the matter simply, we have reached a stage at which high-cost services are growing at a rate that easily outstrips both population growth and any macro improvement in the health of Canadians.

Our current health-care program has, for the most part, already satisfied the basic objectives of the original plan's design. No longer do we need new major hospitals. No longer do individuals face a real

financial barrier in gaining access to health care. No longer can anyone foresee a shortage of physicians. Hospital and medical coverage is more than adequate in quality and availability, and the question of individual affordability has been virtually eliminated.

Nonetheless, the building blocks and incentives used to construct a system that would fill those gaps are still the basis of current initiatives. We continue to pump out more doctors than we need. To service this oversupply, we continue to direct our spending to high-cost institutions with high-tech requirements. This approach is inefficient in that it decentralizes capital investment in facilities and technology. Eventually, it will risk denying our valuable teaching centres enough funding to ensure that they remain world class while it spreads unnecessary technology to hospitals that do not need it and may not support it with the appropriate level of skilled staff. This spiral, in turn, will continue to push the medical profession and institutions away from basic medicine, basic care, and preventative work towards high-tech, invasive procedures. 'Why take a 222 if a CAT scan will do?' Externally, the demand will increase for new beds, new equipment, and complex solutions to simple problems at the expense of competing societal needs, such as social support and environmental problems. A sobering thought, especially when you consider how deficiencies in the latter areas can contribute significantly to health problems.

Directions for solutions

In general, Professor Stoddart's paper provides excellent coverage of the current health-care system and proposes future options that are clearly attractive, even if they are surrounded by a number of question marks.

The suggestion of creating a competitive atmosphere within a publicly financed system is particularly tempting. The development of health service organizations (HSOs) and community health centres (CHCs) would be welcome and could provide a very health-efficient and cost-efficient alternative to total reliance on current modes of delivering medical and hospital services. Yet I must emphasize that I see this development only as a helpful expansion of the current process, not a replacement for it.

In a relative sense, a supply-management approach to hospital budgeting has been effective in cost containment and in beginning

to bring down high bed-to-population ratios and to reduce hospital utilization. Nevertheless, it must eventually be replaced with other, more sophisticated approaches. Such initiatives are underway in Ontario with the co-operation of both the Ministry of Health and the Ontario Hospital Association. Yet although more sophisticated funding approaches may lead to greater efficiency in hospitals, they will not of themselves stem the demand for more beds and more facilities.

In addressing change in the health-care system, I do not see any possibility of sudden or radical reform. My reasons are several:

- Universal prepaid health care is not a negotiable issue for the vast majority of Canadians. Therefore, major reform based on any one fixed ideology is not a realistic prospect.

- The general public satisfaction with our system dictates that change must be accomplished within an area of broad consensus.

- The entire health-care industry is very conservative and would make common cause against any government reform not preceded by substantial consensus building.

- The medical profession is central to the entire health-care system, and its positive participation is essential to any successful reform.

Physicians: their co-operation, their number

The last item in the list brings me to my main point: the role of the medical profession in reform. Physicians are the legitimate gatekeepers of the system, and their participation in reform is essential unless we are prepared to restrict severely their professional and financial independence – a step that I believe would be counterproductive to good health care.

What then is the price of physicians' co-operation, and can it be met? Physicians remain convinced that any change must:

- Leave them independent of the government (that is, they must not become civil servants).
- Not pose a substantial threat to their professional independence.
- Entail no loss of income or related status.
- Not interfere with the physician-patient relationship.

I cannot claim that this list is comprehensive nor that I speak on behalf of physicians, but I believe I have covered their main concerns. Moreover, it seems possible for reform to meet these basic requirements. The idea of placing physicians on salary appears to evoke little interest from government and probably has little public support. Neither do I see any temptation for government to dictate medical practice or to insert itself further into the physician-patient relationship. Therefore, we can rule out the likelihood of radical change being imposed on the physician's standing.

Thus, the physician can – and must – be part of the solution process, not part of the problem. As Professor Stoddart states, 'The key question is who is to control patterns of health-service delivery.' The answer lies in the reality that the physician controls the system by establishing the practice patterns of health-care delivery that he or she desires and thus defines, directly or indirectly, the patterns of service available to others. The physician achieves this control partly by being the repository of a complete medical education married with great practical skills, uniquely qualifying him or her for centre stage in health care. This control is also a product of public respect and confidence. Both kinds of factors are essential to the physician's pre-eminence.

Recently, the rapid growth of the number of physicians practising in Canada has begun to alter that profile. How will this growth affect their pre-eminence? Does the profession see strength in numbers or in its traditional leadership role in the health-care system? If physicians choose the former view, they may effectively abandon their traditional leadership and with it their professional mystique. If they choose neither, they will drift into the role of technicians in a very different system.

Thus, the first step in the reform process must be an examination of the growth in the number of physicians. If we already have an adequate ratio of physicians to population, who benefits from this growth? Aside from the extra physicians themselves, I do not see any material benefit to anyone. What then are the possible disadvantages? More physicians produce more work, which, in turn, costs government more in physicians' fees, and creates a demand for more hospital beds, more hospitals, more equipment, and more staff support.

In the short term, these implications are reflected only in increased government expenditures. But as the numbers continue to increase, the impact on both the medical profession and patients will become more serious. At some critical point, we will suddenly move from a marginal situation of too little work for too many physicians to a stage at which economics demands that the physicians require more patient activity to maintain adequate demand for their services. Then we will risk the real damage of:

- Unnecessary medical services.
- Lower demand, which will eventually bring down physicians' bargaining power and increase tensions in their relationships with government and with other health-care providers.
- Physicians' competing for work currently carried out by other professional groups.
- Increased difficulty in maintaining professional standards.

These developments would damage the very elements that the medical profession most cherishes – professional standing, public image, and incomes.

Thus, we can make a real case for encouraging the medical profession to support a limitation on the numbers of physicians. Limitations would ease the pressure on institutions, lead to more efficient use of resources, and ensure high-quality medicine and appropriate distribution of skills among the professions.

By ensuring that our highest skilled and most broadly educated human resources within the health-care system are limited to an appropriate number, we can also minimize much of the debate and concern over the relative roles of the professions. Physicians will experience no pull to continue paramedical work and thus will better co-operate with and use paramedical resources. This change, in turn, will partly shift the growth pattern away from the high-cost areas of medicine while it protects quality growth and produces more of the financial flexibility needed to support primary health care and illness-prevention programs.

That physicians protect their unique role in the system is important for health care, for health research, and for the medical profession. If they do not face up to the advantages of population control within

this system, they will suffer irreparable damage and, in the process, so will health care.

I do not believe the issue will be simple to manage, but I am convinced it is essential that physicians see that their future strength is not in larger numbers but in maintaining their leadership role. If the medical profession does not review its role and join government to address the problem of numbers, the system will reach a breaking point with disastrous results for health care and the medical profession. I am optimistic about avoiding this situation, but it is essential that the issue be addressed now as the time frame for the implementation of solutions is long.

Health care for the elderly

Another aspect of our system that Professor Stoddart's paper touches on is the demographic pressures of an aging population. Successfully facing this issue means addressing the need for better community support-systems as a viable alternative to quick, unnecessary, and higher-cost institutionalization.

Demographic change also underlines the need for major changes in medical education. Current medical-school curricula are more geared to pediatrics than to geriatrics. We have a system that has not prepared our physicians for the special health problems older people face. The medical academic community and the profession will have to work closely together to design programs better able to address society's needs or our ability to serve people requiring medical care will deteriorate.

Summary

In summary, we have a number of problems developing in what has to date been an outstandingly successful health-care system. The system is a mix of ideologies and contradictions, but it works. Like any complex compromise, it cannot be adjusted easily, but doing so is certainly worth the effort.

We can develop new approaches, more efficient systems, and better relationships between the professions. The answer will not come from any one philosophic approach, however, but from a desire to work together within the system to preserve what is best. Financial incentives and competition policies will play a substantial

role, but we must recognize that an orderly solution cannot be found without the positive involvement of the medical profession. The key to this involvement is physicians' recognition that it is in their best interest as it is in the best interest of the health-care system.

Change requires the active involvement of health-care workers marked with enlightened self-interest. It also requires that the federal government show determination to climb down from its whitewashed stallion and start working with the provinces to create the incentives and the support necessary to catalyse change.

Discussion

JOHN ELEEN (Ontario Federation of Labour): I would like to make a couple of suggestions for cutting health-care costs. First, I think the universities should be turning out more people like Professor Stoddart. We talk about having too many doctors: let's train some of these students to combine economics with medicine.

Second, I think that doctors are operating as one of the most powerful unions in Ontario, so they should come under the Labour Relations Act. When they make a deal with the province on the fee schedule, they should have to stick to it, just as employees have to stick to the contract they negotiate through their union. What the doctors are doing now with extra billing is as ridiculous as a nurse saying to a patient after changing a dressing: 'Now give me 75 cents for this work because the hospital isn't paying me enough.'

Another point is that we don't appreciate how good a system we have. To find out what a private health-care system costs patients, talk to a Canadian who's had the misfortune to fall ill while visiting in the United States. There are plenty of true horror stories about people being handed bills for $100,000 for a stay, being charged $100 each time a doctor made rounds.

This is not to say that our system is perfect. One of its main problems is that our insurance plan is a sick plan. What we should be striving for is a health plan, one that deals with rehabilitation and preventative medicine as well as sickness. If we did more work in that direction, I think we would have a good health plan.

Along the same lines, I agree with Professor Stoddart on the desirability of getting nurses more involved in this kind of work and of starting more health-care centres like those in St. Catharines and

Sault Ste. Marie. Such centres are a very efficient way of bringing health care to the people, and there isn't enough pressure for that.

MONIQUE JEROME-FORGET (Health and Welfare Canada): The previous discussion seems to suggest that we are perhaps spending too much in the health field. I would like to ask our panelists if indeed we are overspending on health care. We seem distressed by the fact that we are now spending 8.4 per cent of our GNP on health care. Yet the cost of many other services and utilities also has increased over the years. One such example is the cost of owning a car – which is close to $3,000 a year – and over which few people debate in deciding whether they're going to own one or not. We spend approximately $1,000 a year per Canadian on health care – just a little more than what a family spends on a car. I therefore question the allegation that health care is too costly and I would like our panelists' views on this.

GREG STODDART: On the surface, the question of overspending or underspending is one of allocational efficiency and so should be amenable to investigation and resolution. But it's not that easy.

Clearly, the present level of funding can't, in itself, be an argument for spending either more or less. There has to be a comparison to some norm or standard, theory or paradigm. So what can we compare our spending to? Well, we can compare it to what we have previously spent on health. But since we don't know whether the previous level was 'correct', that exercise tells us only that expenditures are increasing.

We can also compare our expenditures to those of other jurisdictions. Here we find that our health-care spending, as a percentage of GNP, is higher than that of the United Kingdom, and lower than that of the United States. But those two countries have very, very different systems – so different, that the policy spectrum is sometimes defined as between a UK style and a US style. I think the points in my paper about the complexity of that spectrum underline the uselessness of such international comparisons.

What else can we compare our spending level to? We can compare it to the expectations of some key actors in the system. Here is where we start to realize that the question of underfinancing versus overspending is not primarily an efficiency issue. It's an incomes issue

masquerading as an efficiency issue. What we're really talking about is the relative income position of providers of health care. That's an important point to remember: every expenditure on health care accrues somewhere else as income. (That statement reminds me that I am always puzzled by providers' suggestions that they would like to have deterrent fees in place to cut health-care costs. I really can't believe that they want to cut their own incomes.)

Since the question is one of incomes, posing it in terms of efficiency, of overspending or underspending, isn't appropriate. There is no answer to it other than the one I presented in the paper: we are concerned about costs, whether or not we are overspending in the sense of overall efficiency, because there is substantial evidence that we could be doing better with what we are spending. In that sense, we are overspending.

WILLIAM WATSON: Regarding the overspending in health care, I am just not interested in international comparisons of percentages of GNP. The fact that my neighbour spends 50 per cent of his income on housing doesn't mean that I am going to do that. I spend what I think I get value for. The proper comparison is between what we pay for services and what we could pay for them and also what we value them at. If we now pay $1000 a head, perhaps we could get the same delivery for $800 a head. That would be value for service. Rigidities in the system now prevent consumers from getting that price information, but I am not convinced that we couldn't loosen up the system so we could get better information.

MONIQUE JEROME-FORGET: My second point concerns the double standard that we have when it comes to a possible oversupply of doctors as opposed to other professionals. We believe that it is necessary to control the number of physicians that we train in order to ensure that they will be able to work productively in their chosen fields. Yet we never attempt similar controls in other professions, such as engineering and law. We do not seem to believe that the market will determine the value of physicians. There also seems to be a resistance towards decreasing this value.

GRAHAM SCOTT: The substantial difference between physicians and, for example, engineers and lawyers is that physicians operate in a

closed system. That may mask some of the negative effects of the watering down of professionalism. In my opinion, if the numbers in any profession grow beyond the point at which individuals in it can obtain a reasonable market return on their education and investment of time, that oversupply is bound to be reflected in lesser-quality work, on the average.

WILLIAM WATSON: I am not convinced that an oversupply of physicians exists. The determination of surplus or shortage is usually done by looking at population-physician ratios across countries, which seems to me a highly flawed methodology.

MONIQUE JEROME-FORGET: Professor Watson, many people suggest that extra billing might deter overutilization of service. But might it not generate the opposite behaviour? That is, if I pay a little bit – say, 10 or 15 per cent of the cost – I'll feel more entitled to use the services because I may not know the real cost.

WILLIAM WATSON: Extra billing probably does work as a deterrent. If I have to pay $10 to go to a doctor, I'm less likely to go and he is less likely to have me come back four or five times, spinning patients as the phrase goes. I'd like to see a system in which physicians were paid according to the benefits of what they do as those benefits are perceived by the consumers. What we are using now is essentially a medieval system of the just price. I am not convinced, however, that extra billing is a good system. In fact, it's probably the worst of both worlds. So an attack on extra billing may be reasonable. But as I interpret the Canada Health Act, price rationing simply is not going to be allowed in any way, shape, or form.

The main point that I'd like to emphasize, however, is that whether or not there's a role for government in the supply of health services, I can't see any compelling reason why it's the federal government that has to be involved.

DIANA DICK (Registered Nurses' Association of Ontario): Just a comment on the term 'practitioner' in the Canada Health Act. Two of the amendments to the act touch on the concept of health-care practitioners. Section 2 defines 'health-care practitioner', and Section 9 contains further pertinent wording; both, in effect, describe all

health-care practitioners as forming one set of practitioners with individual kinds, such as doctors, nurses, dentists, physiotherapists, and so on, as subsets. Many people perceive this inclusive definition as a conceptual breakthrough, but, in effect, it changes nothing. Before the passage of those two amendments, the provinces could have used various kinds of practitioners to deliver care, and they still can. The new definition does, however, provide moral suasion for using nontraditional methods of dividing delivery among various kinds of practitioners. Thus, I think it is an important change. It may help us develop alternative care systems that are much more economical and perhaps more compassionate than those we now depend on. By that I mean that there is a need to assess, monitor, and control acute-care costs, and to develop community- and home-based care as integral parts of our health-care system.

Specifically, the development of community- and home-based services would facilitate greater flexibility and access to health care by allowing other health-care practitioners and not just doctors to serve as the first point of contact (or gatekeeper) in the health-care system. Such development would serve to better meet individual health-care needs and also help save acute-care facilities for those who really need them. In practical terms, more home- and community-based care would mean that there would be alternatives for those who don't really need acute-care services, as well as more home-support services for individuals discharged from hospitals earlier. An added benefit could well be the prevention of some serious illnesses through earlier intervention and health promotion. In short, there is a serious need to rationalize health-care services, to assess the system with attention to regionalizing services, and to reallocate resources – human, financial and structural – if we are to continue to be able to afford our publicly funded health-care system.

One further point. Although I enjoyed the comments at this morning's discussion, I noticed that all the speakers presumed the medical model of delivery of care that is prevalent in southern Canada but not in northern Canada, where nurses provide gatekeeper functions. Perhaps the whole country should look to the North for appropriate models.

PART VII
EQUALIZATION PAYMENTS

Equalization payments in the 1990s

Thomas J. Courchene

The 1982 federal-provincial fiscal arrangements ushered in a new equalization program – the 'representative five-province standard' (RFPS). This system replaces the 'representative national-average standard' (RNAS), which, with some modifications, had been in place for fifteen years. This paper focuses on the implications of this change and, more generally, on the role of equalization within the context of the fiscal arrangements.

The first section of the paper describes briefly the rationale for the switch to the five-province standard. To anticipate the analysis somewhat, the RFPS did indeed 'solve' many of the problems that came to be associated with the RNAS. However, the RFPS also created some serious problems of its own, so much so that I believe it is unlikely to survive the next iteration of the fiscal arrangements. An elaboration of these themes, including an assessment of some of the alternatives that will likely be on the table in 1987, constitutes the third section of the paper. Sandwiched between these two parts is a short statistical section on the role of equalization in provincial finances. The final sections of the paper focus on equalization as it relates to some broader issues – the fiscal arrangements, economic efficiency, and the division of powers. A short conclusion completes the analysis. Events subsequent to this conference required the addi-

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tion of a postscript outlining the implications of the Canada-Nova Scotia deal on offshore resources and the impact that this agreement is likely to have on the evolution of equalization payments.

THE 'REPRESENTATIVE FIVE-PROVINCE STANDARD'

Under the new equalization formula, all provinces will, at minimum, have access to a level of per capita revenues equal to the product of the national-average tax rates for each revenue source and the corresponding per capita tax bases averaged over the five designated provinces – British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. In contrast, the RNAS approach applied national-average tax rates to per capita tax bases averaged over *all* the provinces. This change in the *standard* of equalization – from the national average to the average of five designated provinces – constitutes the major alteration in the program.

The rationale for RFPS

The rationale for the alteration in the standard of equalization rested in a series of problems associated with the RNAS that the switch seems to resolve.

Uniformity of treatment of tax sources: energy

Principal among these concerns was the manner in which the RNAS program treated energy revenues. There were really several issues at stake here. First, because of the fear that mushrooming provincial energy revenues would drive the program, the 1977 revisions to equalization allowed only 50 per cent of nonrenewable resource revenues to enter the formula. This was a continuation of a policy adopted in the fall of 1974 which limited the amount of energy revenues allowed to enter the formula. They also placed an overall 'resource cap' on equalization: no more than one-third of total equalization flows could arise from the resource categories, renewable as well as nonrenewable. Later in the 1977-82 period, one energy category was phased out of the program (sales of crown leases were phased out by 1982).

Since Alberta is not one of the provinces included in the five-province standard, the energy-related tax base under the RFPS is much smaller than that under the RNAS. In turn, this allowed 100 per

cent of all energy-resource revenues to enter the new formula. Indeed, as will be demonstrated below, even with 100-per-cent revenue eligibility, equalization flows arising from energy fall dramatically under the RFPS.

Thus, the RFPS fosters uniformity of treatment, in that 100 per cent of all revenue sources now enter the formula. Moreover, the equalization program is now relatively immune to the large swings in Alberta's resource revenues (an important consideration in fall 1981 and spring 1982, when the revisions were worked out). In addition, the downplaying of resource-related equalization obviates the need for a 'resource cap'.

The personal income override

Ontario qualified for equalization payments under the RNAS formula in each of the five years from 1977 to 1982, but it was prevented from receiving them by a provision known as the personal income override – no province was eligible for equalization if its per capita income in the current year and the previous two years exceeded the national average. This provision was binding only on Ontario, and it was so designed.

This arbitrary method of excluding Ontario from receiving equalization payments was of considerable concern since it tended to erode the program's conceptual underpinnings. Indeed, concern over Ontario's role within the scheme was probably one of the principal reasons for the shift from the RNAS to the RFPS. Under the RFPS formulation, Ontario is also ineligible for equalization flows, but this time its exclusion derives from the workings of the RFPS formula, thanks, once again, to the manner in which the RFPS downplays resource revenues. While excluding Ontario on the basis of the formula is more acceptable than the old method, the exclusion still remains somewhat arbitrary since the shift in the standard was arbitrary.

Increasing comprehensiveness

A long-standing complaint of many recipient provinces has been the exclusion from the RNAS formula of separate categories for municipal revenues – in particular property taxes for local purposes and miscellaneous local revenues. The 'savings' from the manner in which

the RFPS handles energy allowed the designers to expand the program to encompass these municipal revenues. In this sense, the RFPS has made the equalization program more comprehensive in its coverage.

Other features of the RFPS

The new formula applies both upper and lower bounds to equalization flows. On the upper side, equalization is capped by the growth rate of GNP from a 1982/3 base; a set of minimum-level guarantees provides the lower bound. In addition, a system of three-year transitional guarantees protects those provinces that would otherwise suffer inordinately as a result of the move from the RNAS to the RFPS.

Summary

To the extent that equalization has a political dimension, as it surely does, the RFPS approach appears to come away with excellent grades. Uniformity of treatment of tax sources has been re-established, coverage is more comprehensive, and the exclusion of Ontario is formula-based rather than legislatively decreed. However, there is less here than meets the eye; as we shall see in a later section, the RFPS approach has generated some new problems that are probably more disconcerting than those its designers sought to alleviate.

EQUALIZATION IN ACTION

Before we focus on the problems the RFPS has created, it is instructive to devote some time to the role that equalization plays in the finances of recipient provinces.

Provincial disparities

Table 1 presents some data pertaining to equalization flows and their impact on the various provinces' finances. Row 3a shows the disparity in the provinces' revenue-raising abilities. For example, Prince Edward Island has access to revenue from its own sources equal to 55 per cent of the national (all-province) average per capita. Alberta's access is four times as great – 217 per cent of the national average. And if the Alberta tax rates were at the P.E.I. level, Alberta's access

TABLE 1
Equalization payments and provincial finances

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Total	'Representative' five provinces[b]
1 RFPS equalization (1982-3)												
a) Per capita transfer ($)	912	1007	708	701	382[a]	0	340[b]	0	0	0		
b) Total transfer ($ million)	522	124	606	490	2466[a]	0	349[a]	0	0	0	4557	
2 RNAS equalization (1982-3)												
a) Per capita transfer ($)	916	989	723	720	461	[c]	495	0	0	0		
b) Total transfer ($ million)	524	121	618	503	3013	[c]	509	0	0	0	5289	
3 Disparity Indices (% of all-province per capita average) 1981-2												
a) Own-source revenue	59	55	66	66	78	94	79	112	217	111	100	91
b) Own-source revenue plus equalization	83	83	84	84	86	88	88	105	203	104	100	90
c) Own-source revenue plus all transfers	90	96	89	92	90	87	90	106	186	102	100	91
d) Tax effort (on own-source revenue)	102	99	84	86	121	100	97	104	79	102	100	107

NOTES: These data are based on forecasts of revenues as of early 1982. Given the severity of the recession, which was not forecast in the projections, these estimates were on the high side. However, our interest is principally in comparing the results of the RFPS and what a continuation of the RNAS would have generated. The recent downturn may have influenced the comparative relationships but much less than the absolute values.

a These estimates do not include the transitional-guarantee provisions that would have come into play for Quebec and Manitoba under these forecasts.

b The provinces used for the RFPS – British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec.

c The exclusion clause of the RNAS would have prevented Ontario from receiving equalization payments, although the formula would have entitled Ontario to receive some equalization.

SOURCE: Courchene (1984, chap. 4 and 12).

would be between five and six times P.E.I.'s (from row 3d, P.E.I.'s tax effort is 99 per cent of the national-average level, whereas the comparable figure for Alberta is only 79 per cent).

Equalization flows dramatically enhance revenue access for the recipient provinces, as shown in row 3b. After equalization, P.E.I. has 83 per cent of the national average. When one includes other federal-provincial transfers, such as those for established programs financing (EPF) and the Canada Assistance Plan (CAP), the disparities shrink further; P.E.I. now has 96 per cent of the all-province revenue access (row 3c).

An interesting comparison in row 3c is the group of 'have-not' provinces plus Ontario, (that is, all the provinces except the three westernmost). The range is relatively narrow – from 96 per cent for P.E.I. to 87 per cent for Ontario. Thus, in this context, equalization can be seen to be fulfilling its role of ensuring that all provinces have access to per capita revenues roughly equal to the national average. Alberta is the only real outlier with an index of 186.

Two other features of panel 3 merit attention. First, it shows that Ontario has the lowest revenue access per capita of any province. From row 3d, which presents indices of tax effort, it is clear that Ontario's low revenue situation is not caused by a low tax effort (its tax-effort index is 100).[1] This finding should *not* be surprising since it is the reason Ontario qualified for equalization during the 1977-82 period (although the personal income override then made it ineligible).

The final column of panel 3 contains information on the five provinces that make up the new standard. For the category 'own-source revenue plus all transfers' (row c), the RFPS average is 91 per cent of the national average. This also holds true for own-source revenue. Hence, the RFPS will lead to lower overall levels of equalization than the RNAS because the standard is lower. Interestingly enough, the index of tax effort for the RFPS provinces exceeds the all-province average (row 3d).

RFPS versus RNAS

RFPS equalization flows for 1982/3 appear in panel 1 of the table; panel 2 presents the equalization payments that would have been generated if the RNAS formula had remained in place.[2] The first point to note is that Quebec and Manitoba are the big 'losers' in the

shift from the RNAS to the RFPS. In large measure, this outcome is the reason for the new program's minimum and transitional payments.

The second interesting point is that the RFPS generates smaller overall flows than would have occurred under a continuation of the RNAS, even though the RFPS is more comprehensive and has 100 per cent of all energy revenues entering the formula. The reason is, of course, that energy revenues generate much less equalization under the RFPS, even though 100 per cent of energy revenues enter the RFPS formula. As demonstrated elsewhere (Courchene 1983, table 3) energy-related equalization for 1982/3 totals $768 million under the RFPS, compared with a flow of $1903 million were the RNAS regime still in place. Quebec and Manitoba suffer from the transition primarily because under the RNAS their energy-related equalization as a proportion of total equalization was larger than that of the rest of the 'have-not' provinces. Indeed, Manitoba's projected equalization for 1982/3 as generated by the RFPS ($349 million) is less than its 1981/2 level under the RNAS, although its entitlement will be topped up by the transitional guarantee.

PROBLEMS WITH THE RFPS

Although the RFPS addresses some of the problems that beset the previous equalization program, the new system has some very disconcerting features. The first of these is that the RFPS formula, *per se*, is essentially *irrelevant* in determining the levels of equalization, at least currently. The latest available data on the program indicate that the payments to all provinces except Newfoundland are being determined by the transitional guarantees.[3] But these guarantees apply for only three years. Afterwards, it is likely that Manitoba, for example, will fall back on the RFPS's minimum-payment feature,[4] which will almost certainly reduce its entitlement. Even though one can lay much of the blame for this situation on the recession, it does not augur well for the new program. Politically, how does one go about telling Manitoba that after the three-year transition period it is in for yet another fall in equalization?

A second set of problems arises from the new standard itself. Because five provinces are included and five are excluded, the equalization payments arising from a corporate-headquarter shift, for example, will now depend on whether the provinces of origin and destination are in or out of the standard.[5] As a practical matter, this

may not be very significant. However, as a conceptual issue, it is rather troublesome since equalization flows to Nova Scotia, for example, should in principle not be a function of whether economic activity leaving (or entering) this province settles (or originates) in Alberta or in Ontario.

By far the most serious problem with the RFPS system arises from its treatment of resource revenues in 'have-not' provinces. The mathematics of the new formula are such that if a province not included in the standard (for example, Newfoundland) finds itself with an enhanced resource base, the tax-back rate is 100 per cent – that is, the province will lose one dollar in equalization for every dollar increase in resource revenues (see Courchene 1984, technical appendix). Moreover, if this province's tax rate or royalty rate is lower than the national-average rate or if it spends funds to develop its resource base (say, by developing its infrastructure or enlarging its civil service), the offset will be more than 100 per cent.

There are two types of incentive issues here. First, not only are confiscatory taxes generally unacceptable; they are also generally uncollectable. Second, the RFPS's effective tax rates on resource revenues vary dramatically across provinces. For 'have-not' provinces outside the standard, the tax-back rate is 100 per cent or more. For 'have-not' provinces within the standard, it is less than 100 per cent, and for 'have' provinces, of course, it is zero. It is true that some of these problems arose under the RNAS approach (although 100-per-cent tax rates were not possible), but the disincentives for resource development in the poor provinces were much smaller because only 50 per cent of resource revenues entered the formula.

ALTERATIONS FOR 1987

For these and other reasons it seems to me that the RFPS does not have a very secure future. The most likely *practical* alternative is what is referred to as RNAS-20 – the 'representative national-average standard' for nonresource revenues with 20 per cent of resource revenues entering the formula. This system was the official proposal of the government of Saskatchewan in the 1982 deliberations[6], and it was also the implicit recommendation of the Breau Task Force (Canada 1981). In addition, RNAS-20 is pragmatically very close to the preferred approach of the Economic Council of Canada (1982), although the ECC's theoretical justification for its proposed program

rested on different grounds.[7] The official Quebec approach, although more complicated both conceptually and empirically, can also be interpreted as consistent with RNAS-20 (see Courchene 1984, appendix to chap. 11).

Among the results of an RNAS-20 approach would be:

- The incentives for resource development would be enhanced considerably relative to those under the RFPS.
- Energy-related equalization would be effectively identical to that arising from the RFPS, although the distribution across provinces would be different (and more appropriate).
- By formula, Ontario would remain excluded from receiving equalization.

All in all, RNAS-20 is a viable alternative to the RFPS and certainly a leading candidate for the 1987 equalization program should the present approach run into disfavour.

Of course, other approaches also warrant consideration. For example, the literature contains many suggestions of what is often called a 'macro approach' – replacing the thirty-odd individual tax bases in the equalization formula with a single macro indicator such as the provincial gross domestic product (see Courchene 1984, chap. 7). The move from the RNAS to the RFPS has enhanced the viability of a macro approach since the latter generates equalization flows that are very similar to those that would arise within the context of a macro formula.

Another alternative would be to divide resource revenues from the rest of the program, equalizing them separately via an interprovincial revenue-sharing pool; the resource-rich provinces would contribute a share of their revenues (say, 30 per cent), and the resource-poor provinces would draw an equivalent share from the pool. This proposal has some desirable features: it would enhance interregional efficiency, and it would probably result in a decrease in the overall size of government. However, the pool approach, like the macro approach, would be a radical departure from the status quo; as such, neither is probably a viable alternative, at least for the 1987 revision of the program.

In the near future, progress is more likely in refining the definitions of resource revenues. At present, not all provinces maximize their tax

or rent collections from resources. Some prefer to allow these rents to accrue to citizens in the form, for example, of prices for electricity that are lower than would otherwise be the case. Of course, the provinces have the right to do this. But it does not seem appropriate that a province that opts to collect such revenue should be deemed 'richer' in resources than a province in an essentially similar position that decides to transfer potential revenues back to its citizens. To be sure, this issue is controversial. Nonetheless, it is obvious that the present system, which focuses only on actual revenues, underestimates the revenue potential of those provinces that do not opt to collect their resource rents or royalties. Many other examples of desirable tax-base changes could be proferred, but none would have as much impact as bringing potential rents into the definition of tax bases.

EQUALIZATION AND FEDERALISM

Let us now leave the specifics of the RFPS and its alternatives to turn the focus to some broader aspects of equalization. In what follows, I shall restrict my comments to three general areas, although many more undoubtedly merit attention.

Equalization and the fiscal arrangements

Manitoba felt that the 1982 fiscal arrangements dealt it a double blow. Like the rest of the provinces, it suffered the impact of the rollback of the EPF transfers. In addition, the switch from the RNAS to the RFPS also dealt Manitoba a severe revenue loss. This situation raises the question of whether equalization should be a separate, quasi-independent program or should be linked much more closely with the rest of the intergovernmental transfers associated with the fiscal arrangements.

As an outside observer at the Federal-Provincial Conference of First Ministers on the Economy in February 1982, I gained an impression that the federal government skilfully played off the Atlantic provinces against the rest in devising the trade-off between the EPF and the equalization transfers. This gambit may indeed fall well within the traditional framework of federal-provincial bargaining. However, consider a quite different alternative. Suppose that equalization were a residual program so that regardless of the

particular arrangements adopted for the established programs, the 'have-not' provinces would be guaranteed that their revenues would be brought up to some agreed level. (The existing equalization program meets this requirement, but only to a limited degree.) Under the alternative approach, the planning process for the 'have-not' provinces would be made more predictable, and the EPF transfers could be determined on their own merits. If the EPF transfers were lower than expected, equalization payments would fill up the fiscal-capacity gap, and vice versa. Thus, equalization would become the overarching program within the fiscal arrangements.

In one version of this approach that I have elaborated on elsewhere (Courchene 1984, chap. 8), equalization would even adjust to transfers under the umbrella of federal-provincial development agreements, unless they were explicitly specified as exempt from the equalization override. Moreover, the equalization (or 'regional') aspects that currently exist in other federal programs would be eliminated, radically altering the overall nature of federal policy toward the regions. The effect would be a call for a more market-oriented approach to allocation, limiting distribution initiatives to the equalization formula.

As an important aside, I suggest that this approach to equalization is probably the one most consistent with a literal reading of the new constitutional provision:

> Parliament and the government of Canada are committed to making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. (*Canada Act*, 1982 36 [2])

This provision appears to specify that equalization should be tailored to provincial *expenditures* rather than provincial *revenues*. In Courchene (1984), I devote a chapter to what might be termed 'representative-expenditure approaches' to equalization as distinct from Canada's traditional 'representative-tax approaches'. Much important spadework would have to be undertaken before such a system could be operative. However, the possibility does exist that, in response to a constitutional challenge, the courts would require a reworking of equalization along the line of such an expenditure approach.

I hasten to add, however, that my proposal is motivated more by a desire to ensure stability of and, more importantly, predictability of revenues for the poorer provinces and by my own (perhaps misguided) preference for a system of federal-provincial bargaining that does not lend itself so easily to a federal 'divide-and-conquer' strategy of playing rich and poor provinces against each other. Moreover, I do not mean to downplay the ways in which the present equalization program is already partially integrated with the rest of fiscal arrangements, particularly in respect to tax transfers. Suppose, for example, that Ottawa reduced its EPF cash transfers to the provinces and, instead, gave them more 'tax room'; the existing equalization program would ensure that the provinces with low tax capacity would not suffer financially as a result of this policy shift. (This very significant feature of the current equalization program is dealt with in more depth below in the subsection on equalization and the division of powers.)

Equalization and efficiency

Equalization inhibits the outmigration of labour from the equalization-receiving provinces. Of this, there is little doubt, analytical or empirical. What is in considerable doubt is the resulting implications for economic efficiency. One school of thought is that equalization payments run counter to efficiency because they inhibit natural adjustment forces: when transfers reduce the tax-price of public services in the home province, labour is less inclined to seek higher rewards elsewhere. The counter-argument, that equalization is efficiency-enhancing, runs as follows. Because of differences in the provinces' fiscal capacities, particularly in their resource rents, net fiscal benefits vary considerably across provinces. As a result, prospective migrants take account of both market incomes and net fiscal benefits in their calculus. Hence, an individual or family may make an interprovincial move that involves accepting a lower level of market income if the apparent loss is more than offset by larger net fiscal benefits in the receiving province. This phenomenon, which is referred to as 'fiscal-induced' or 'rent-seeking' migration, may be optimal behaviour for the individual or family, but it runs counter to national efficiency. An equalization program that equalized net fiscal benefits across provinces would ensure migration dictated more by market than by fiscal considerations.

Both arguments offer an important element of truth. Were P.E.I.'s equalization payments reduced to zero from the present level of nearly $1000 per capita, it seems clear that the exodus of people would include some who, on productivity (efficiency) grounds, ought to remain in P.E.I. Similarly, the fact that P.E.I. and Newfoundland do receive almost $1000 per capita in equalization payments surely inhibits the migration of persons who, on efficiency grounds, ought to be located elsewhere.

I think it rather clear, however, that the recent Canadian equalization programs (RNAS or RFPS) cannot be defended on grounds of efficiency. Consider the RNAS program. The existence of massive resource rents in the Western provinces led to the situation in which Ontario qualified as a 'have-not' province (even though only 50 per cent of resource rents entered the formula). The fact that Ontario was denied equalization implies, in terms of fiscal-induced migration, that too many Ontarians moved to Alberta and also that too few Atlantic residents came to Ontario. Hence, it is very difficult to make the case that Canada's method of equalization is motivated principally by efficiency concerns. Hence, economic theorists, whose motivation is clearly efficiency oriented, favour some sort of interprovincial sharing whereby provinces with high net fiscal benefits would pay into a pool and provinces with low fiscal benefits would draw from it.

My own view on this issue has always been that, overall, equalization runs counter to efficiency; that it does impede the natural processes of economic adjustment. In this context, it is interesting to note that the United States does not now have a formal equalization program. As Wallace Oates, one of its leading public-finance experts, recently remarked (1984), net fiscal benefits undoubtedly differ across the American states, but just as likely these differentials are *capitalized* so there is no need on efficiency grounds for an equalization program. I think that much the same applies in Canada – the efficiency arguments for equalization assume that the net fiscal benefits will not be fully capitalized in terms of land values or site rents, an assumption that I find difficult to accept. On this basis, Professor Oates concludes that equalization systems are basically a matter not of efficiency but of 'taste' (that is, of societal preference).

Although it is important to sort out the efficiency implications of

our equalization system, the principal justification for the program rests on other concepts. Specifically, the system of equalization payments has allowed Canada to maintain, and perhaps even enhance, the degree of decentralization that distinguishes this country from many federations and certainly from the United States.

Equalization and the division of powers

The conceptual forerunner of Canada's equalization program was the system of 'national adjustment grants' proposed in the Rowell-Sirois Report (Canada 1940). Interestingly enough, the report's rationale for equalization had more to do with what I would call constitutional or federalist arguments on the one hand and nationhood arguments on the other than with economic theorizing. In spite of the fact that the Rowell-Sirois Report can be viewed as a centralist document, recommending, as it did, the transfer of all direct taxation to the federal level, it was a staunch defender of the provinces' rights in those areas of expenditure falling under provincial responsibility. And unconditional equalization transfers were to be the principal instrument for guaranteeing this autonomy. In effect, this is the constitutional or federalist argument for equalization – for provincial autonomy to have meaning, the provinces need revenues sufficient to act in those areas in which they have constitutional responsibility. The nationhood argument is based on the notion that there are certain types of public goods and services to which all Canadians should have access as a right of citizenship. To the extent that some of these goods and services fall under provincial jurisdiction, equalization-like transfers are needed to ensure that all citizens have some minimum level of access to them. (Some economists interpret this rationale in terms of the public-finance notion of horizontal equity, but I prefer the emphasis on nationhood.)

This way of approaching equalization carries several important implications. First, even if one can demonstrate that equalization payments run counter to efficiency, doing so may have little impact on the program since it draws much, if not most, of its rationale from a domain other than economics.

Second and relatedly, equalization is not just a program for the 'have-not' provinces. The nature of our equalization program has allowed the federation to decentralize via the transfer of 'tax room' rather than, for example, via transfers of cash. The richer provinces

prefer this approach because it enhances their flexibility and autonomy. Indeed, they tend to view the revenues from this enhanced 'tax room' as part of their 'own' revenues and not as a component of federal-provincial transfers.

Some historical perspective is needed here. The philosophy underpinning the Rowell-Sirois Commission's rationale for recommending 'adjustment grants' was very similar to that associated with the equalization system (as reflected, for example, in the new constitutional provision). But the similarity ends here. Recall that the Rowell-Sirois Commission recommended the transfer of direct taxation to the federal level, and its approach to equalization was to be implemented within this framework. But the formal equalization program was inaugurated only when the system of direct taxation had moved once again toward *decentralization*. This was no coincidence. The poorer provinces would accept decentralization via increased 'room' for direct taxation only to the extent that they could share 'fairly' in the process. Indeed, this is one of the reasons the equalization standard was defined in the early years in terms of the yield of the richest two provinces, rather than as the national average. It was only after the program was broadened to include tax sources other than those for direct taxes that the national-average standard became generally accepted.

This way of viewing equalization also provides a rationale for the unconditional nature of equalization payments. Since revenues accruing to the richer provinces from their enhanced 'tax room' can be spent as these provinces wish, it also seems appropriate that the resulting equalization flows to the poorer provinces should be unconditional.

Perhaps I am belabouring an obvious point. Let me summarize it as follows: while the existence of an equalization scheme generally serves to enhance the fiscal positions of the recipient governments, the particular features of the Canadian equalization system formed the groundwork for a rather thorough decentralization of taxing powers in the federation and, as such, are an essential part of the reason the Canadian provinces have more autonomy than the states of most other federations.

This analysis can be carried one stage further. In the absence of a comprehensive equalization program, arguments that Ottawa should bow out of expenditure areas under provincial jurisdiction would

carry little or no weight. With a comprehensive equalization program in place, the converse is more nearly true: since the provinces do have roughly equivalent access to revenue and since they are responsible to their citizens for their policy actions, it is not obvious that the federal government can mount a convincing case for intervention in these policy areas.

CONCLUSION

Equalization serves many purposes in our federation. Hence, it is consistent for an analyst to endorse equalization in principle while arguing that the current program is inadequate in certain aspects. Apart from criticizing some specifics of the new RFPS formula, what I have attempted to emphasize in this paper is the manner in which equalization interacts with both the fiscal arrangements and the division of powers. In this sense, equalization is a program that is important to *all* provinces, not just those that receive equalization.

For this reason, I was disappointed to learn that the province of Saskatchewan has disbanded, or is about to disband, its equalization policy group. This move is understandable since under the RFPS formula Saskatchewan is well into the range of the 'have' provinces and, therefore, is unlikely to be a beneficiary in the near future. Nonetheless, Saskatchewan has, over the years, made very significant contributions to both the theory and practice of equalization, ranging from its important input at the time of the Tax Structure Committee (as Al Johnson reflected at lunch) through to the 1982 revisions, when the province proposed the RNAS-20 approach. It seems to me that since equalization has implications for all provinces, it is desirable that the 'have' provinces continue to maintain an active interest in both the design and the implementation of our system of equalization payments.

Towards this end, the provinces might consider establishing a *small* inter-provincial fiscal secretariat. Its principal function would be fact-finding and research with respect to the fiscal arrangements, although it could also be called upon to play a role in the policy area in connection with the quinquennial revisions. There is a need for standardizing the provinces' measurement procedures across most of the program areas that fall within the purview of the fiscal arrangements. Even more importantly, the secretariat could provide

a valuable, continuing clearinghouse for provincial problems and proposals related to intergovernmental finances.

I recognize that it is all too easy to overestimate the role that yet another institution could play. However, what is important is not the institutional framework I have suggested but rather the underlying notion that the provinces must interest themselves in all the aspects of the complex set of arrangements that comprise the federal-provincial financial interface. This holds with special force for the equalization system, which is the integrating element of the fiscal arrangements.

POSTSCRIPT: THE CANADA-NOVA SCOTIA OFFSHORE DEAL

Shortly after this conference, the governments of Canada and Nova Scotia tabled legislation in their respective parliaments to establish formally in law an agreement reached on 2 March 1982. This offshore-energy deal has many facets, two of them of particular concern for this paper. First, this agreement will

> ensure that the province receives all revenue from offshore activity (with the exception of federal corporate income tax) until its per capita fiscal capacity reaches 110 per cent of national average fiscal capacity, adjusted upward to take account of the extent to which the province's unemployment rate exceeds the national average. These revenues include the Federal Petroleum and Gas Revenue Tax. Once it moves above this level, the province will begin to share the revenue. (Canada 1984, 1)

The upward adjustment for unemployment referred to in the quotation is two percentage points of fiscal capacity for every one by which Nova Scotia's unemployment rate exceeds the national average. Thus, if its unemployment rate is 5 per cent higher than the Canadian average, Nova Scotia will receive all offshore revenues (except the federal corporate tax) until its fiscal capacity exceeds 120 per cent of the national average. The *communiqué* points out that this deal is much better than the one the present energy-producing provinces have.

Second, the agreement contains a provision for

> equalization offset payments which will protect the province for up to 10 years from the full effects of reductions in equalization payments as it gains offshore revenue (Canada 1984, 2).

Under the provisions of this arrangement, the actual equalization program in place at the time will continue to apply, but the minister of energy, mines, and resources will then step in and make payments to offset losses in equalization. The effect of the agreement is that in determining Nova Scotia's equalization payments, only 10 per cent of its offshore-energy revenues will go into the formula in the first year, then 20 per cent in the second year, and so on until full equalization occurs in year ten.

Much of the rationale for the agreement had to do with the then on-going jurisdictional battle over offshore oil. However, the equalization provisions were probably viewed as essential because of the confiscatory nature of the new RFPS program, as outlined earlier.

It seems to me that this agreement represents a most regrettable, retrograde step in the evolution of Canada's equalization program. This type of agreement cannot possibly be limited to Nova Scotia. Already, Conservative Leader Brian Mulroney and Newfoundland Premier Brian Peckford have signed an energy pact that will presumably become law if the Conservatives form the next government. How can Ottawa tell Quebec that its hydro revenues should not also have preferential treatment in equalization? And so on.

In my overview essay in this volume ('The fiscal arrangements: focus on 1987'), I suggest that if the impasse over vertical fiscal balance continues over the next few years, it is likely that horizontal balance (that is, equalization) will also become a more contentious issue. The equalization-offset provisions of the Canada-Nova Scotia offshore deal make this situation almost certain to occur. Hitherto, equalization has been *formula-* or *system-determined*. The possibility now exists that it will degenerate into a set of *bilateral* arrangements, which will, of necessity, be political in nature. Moreover, the entire program will, in my view, now be vulnerable to a court challenge as a violation of the Constitution, Section 36(2).

These possibilities make the 1987 revisions to the equalization program all the more critical. In particular, it now appears essential to redesign the formula to remove the 100-per-cent tax rate on

resource developments in 'have-not' provinces. Such a change is important in its own right, but it would also minimize the impact of the new offshore-oil deal. Once again, something like RNAS-20 appears to be appropriate, provided that the program includes an override to ensure that resource-rich provinces do not receive equalization beyond some agreed level of fiscal capacity.

More generally, Canada's formal equalization program is sure to run into increasing problems if Ottawa continues to incorporate an element of equalization into most expenditure programs and now moves to incorporate equalization-offsets for certain provinces into the equalization formula itself.

NOTES

1 However, were one to adjust the percentages in row 3c for tax effort (essentially dividing row 3c by row 3d and multiplying by 100), then Quebec would have the lowest access to per capita revenues (on a tax-effort-adjusted basis).

2 These data were drawn from early forecasts of revenues for 1982/3. The severity of the recession was such that the estimates have turned out to be considerably on the high side, but they will suffice for present purposes.

3 The three-year transitional payments are determined as follows. Take the annual average increase (in dollars) in the province's equalization during the five-year period 1977/8 through 1981/2 and add it to the 1981/2 equalization payment. The result is the floor level for 1982/3 equalization. For 1983/4, add five-thirds of this average annual increment to the 1981/2 level; for 1984/5 add double the increment to the 1981/2 level.

4 For a province with a fiscal capacity (own-source revenue) of less than 70 per cent of the national average, the minimum guarantee is 95 per cent of its payment for the previous year. For fiscal capacities between 70 and 75 per cent of the national average, the guarantee is 90 per cent, and for the remaining provinces, it is 85 per cent.

5 For an elaboration of this interaction between equalization flows and the location of economic activity, see Courchene (1984).

6 For an elaboration of the Saskatchewan proposal, see Courchene (1984, appendix to chap. 11).

7 The rationale of the Economic Council of Canada (1982) for less-than-100-per-cent equalization of resource revenues is as follows. First, resource revenues belong to the provinces, a fact that distinguishes them constitutionally from other revenue sources. Second, these resource rents represent net benefits to provincial residents since they can be used to finance either additional government goods and services at an unchanged tax rate or the existing level of government goods and services at a lower tax rate. Third, these benefits ought to be (though they are not) viewed as income for personal-income-tax purposes. Given that the federal marginal tax rate is roughly 30 per cent, this view implies that 30 per cent of the resource revenues ought to enter the equalization formula. If one assumes that a portion of these revenues is placed in the various provincial heritage funds and as such ought to enter the equalization formula in the future rather than the present, then a figure more like 20 per cent would be appropriate for equalization.

Although this reasoning differs from that of the proponents of RNAS-20, the

practical effect is that RNAS-20 is consistent with the ECC's preferred equalization scheme.

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Comments
Ron McGinley

Professor Courchene, I reread your paper last night, and I enjoyed it just as much the second time through. It's a very good blend of history and prognostication, abstract economic theory and constitution-building in the old-fashioned, political-economy sense. I think there are insights here for everybody at the conference – economists, lawyers, political scientists, or whatever.

I find myself in agreement with most of what you have to say, especially regarding the problems of the equalization program. There are five things in your paper that I want to comment on this morning.

The 'representative five-province standard' (RFPS)

First of all, I think you have been a little hard on the new equalization standard. You say that the 'representative five-province standard' (RFPS) 'has generated some new problems that are probably more disconcerting than those its designers sought to alleviate'. Then you suggest that this standard has a rocky future and that it's likely to be replaced come 1987.

You talk about three problems with the new system, saying that by far the most serious arises from its treatment of resources in the 'have-not' provinces. This is the old, well-known argument that equalization provides a disincentive to resource development. I am sure that this disincentive occasionally enters into provincial decision-making. I can probably be convinced by algebra and so on that the problem is slightly worse under the new standard than it was under the old standard. And I'm sure that the recipient provinces will raise the issue during the next set of negotiations. But like the federal

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government, I have difficulty viewing this problem as a major one, especially when we look at it in the light of a dynamically developing economy. I certainly can't see it causing us to change the standard or undertake other major surgery. To my way of thinking, the problem is not in the same league as the old problems we had. It's certainly not more disconcerting than the old nightmares that Ontario will become eligible or that resource equalization will break the federal bank.

I think if the new standard is in trouble, it's probably because, as you put it, the new formula *per se* is essentially irrelevant in determining the levels of equalization, at least at the present time. Currently most recipient provinces are on transition payments, and those payments have become unexpectedly large. I agree with you that it is unsatisfactory, to say the least, to have a system of equalization in which payments are determined by the bells and whistles rather than by fundamental principles.

There is certainly going to be some rough sailing ahead here. These transition arrangements do run out fairly shortly, and there is going to be some very hard political bargaining to come up with a solution.

Personally, I think the federal government will be able to pull through without getting itself into another major overhaul of the formula, but it's going to be an interesting development to watch. This problem with the transitional equalization payments is going to be the first major federal-provincial item that the new prime minister will have to tangle with. It will be interesting to see how he deals with this issue. It may be an indication of how negotiations on a broader front are going to be played out over the next few years.

But to return to my first point about your paper. I think you have been a little pessimistic about the new standard. It has some problems, but I don't see its being jettisoned as quickly as you seem to imply.

Residual equalization

My second comment about your paper concerns your suggestion to link equalization more closely to the rest of the intergovernmental transfer system. The idea is that equalization could be a kind of 'residual program so that regardless of the particular arrangements

adopted for the established programs, the "have-not" provinces would be guaranteed that their revenues would be brought up to some agreed level.' You list some of the undoubted advantages of such a system. For example, it would ensure revenue stability for the poor provinces, enabling more planning. It would also allow us to weed out all of the implicit equalization features that are jammed into shared-cost programs, permitting them to be designed with greater attention to efficiency criteria and the market's allocative signals.

However, I think such a system would present a lot of problems that you don't really address. (Perhaps you have addressed them in your forthcoming book [Courchene 1984], and I am being a little unfair to raise them here.) The first question that jumps to mind is, what about Ontario in such a system? Your proposal, if I understand it, amounts to equalizing fiscal capacities after federal transfers. As we can see in your table, Ontario is last among the provinces. Under your scheme, therefore, policymakers would have to choose whether to provide equalization payments to Ontario, cut the transfers to other provinces, or jiggle a lot of the transfer programs in a very arbitrary fashion, building some in and some out, to get the right kind of mix. In other words, the Ontario problem that has plagued the equalization program for the last five or six years would still exist in the kind of scheme you have mentioned.

Second, it's not at all clear to me how you would determine this agreed-upon level to which everything is going to be geared. At present, the equalization formula generates a total entitlement as well as a distribution pattern; what you seem to be talking about is a program in which the target level of per capita revenues is somehow determined *outside* the representative tax level. But who would determine the level? How would it change from year to year? What would happen as fiscal capacities change over time? One of the attractions of the current approach is that it is sensitive to all developments in provincial economies, and I would be reluctant to see this flexibility given up in favour of overt political bargaining over dollars.

Moreover, I think your approach insulates the budgets of the recipient provinces, but not those of the wealthier provinces. What would happen if, for example, Ottawa cut EPF payments? With equalization as a residual item, the recipient provinces would have

the cut offset. But the wealthier provinces, which do not have this equalization residual, would be forced to bear the entire burden of federal restraint.

I also think this scheme might cause the recipient provinces to lose interest in the design of transfer programs generally, since no matter what happened, they couldn't lose dollars. What incentive would they have to work with the federal government in considering new initiatives and redesigning old ones if the dollars were always guaranteed? I still think that residual equalization is a good idea, one that's certainly worth pursuing, but the problems I have mentioned will have to be addressed.

Efficiency – how much?

My third comment is a quick one on efficiency. In your paper, you say you are concerned about equalization because 'overall, equalization runs counter to efficiency'. You also remarked yesterday morning that in the future the country is going to have to pay much greater attention to efficiency in the design of its public-sector programs (see 'Fiscal arrangements: focus on 1987' elsewhere in this volume).

Now, I don't want to be too simplistic. Efficiency involves the design of the program as well as the total volume of resources being redistributed. But I do have a question here on behalf of conference participants, such as Ian McBain from New Brunswick, who would like to have their 'fright function' quantitified, so to speak. Do you think equalization is too rich, and if so, by how much would you bring it down – 10 per cent? 15 per cent? 20 per cent? What, in your opinion, has to be done with this particular program if we are to establish a more appropriate balance overall between equity and efficiency objectives?

Equalization and decentralization

My fourth observation concerns your statement that equalization has 'allowed Canada to maintain, and perhaps even enhance, [its] degree of decentralization' as a nation. This observation is valid, but the argument can be taken further. It goes beyond the question of provincial autonomy, which, in an abstract sense, could be obtained simply by instituting a vast program of unconditional grants, provided constitutional entrenchment or some other mechanism

prevented discretionary changes from year to year. I think what you are really saying is that because of equalization we have been able to get not only provincial autonomy but also accountability. That is, we have decentralized and we have done it on the tax side, and from the point of view of political theory, that's probably the best way to have gone about it.

An interprovincial fiscal secretariat

My fifth point relates to your suggestion of an interprovincial fiscal secretariat to do research and fact-finding for the working out of the fiscal arrangements. I think the proposal reflects a bit of pessimism. After all, we do have an organization that is supposed to be doing that – it is the Federal-Provincial Continuing Committee of Officials on Fiscal and Economic Matters, in which finance officials of the federal government and the provinces sit down together and are supposed to do the fact-finding and the research. I'm just a little troubled by your apparent belief that officials of the two levels of government really can't work together at this kind of thing. I see ten provinces getting together on their own as an approach that would inevitably heighten confrontation because it would look like a gang-up. We have to get the Continuing Committee working better, and I think we should concentrate on that.

Discussion

DOUGLAS CLARK (federal Department of Finance): We in the Department of Finance are particularly interested in hearing from the academic community in a number of areas relating to equalization. Certainly, one of these is equalization and efficiency. Although economists continue to disagree on this matter, more of a consensus is emerging. We encourage you all to keep writing in this area – I think, for example, that Tom Courchene's book will contribute enormously. We would like to see emphasis, too, on how the receiving provinces spend the money they get and on the economic implications of this spending. For example, what is happening to public-sector wage rates in these provinces? What implications does this have for wage rates in the private sector? We are also interested in the matter of equalization of rents forgone for hydro-electricity. The economists who have written on this subject disagree,

particularly on the measurement. Yet from a practical viewpoint, it would be helpful to have more of a consensus on the matter. Useful work could also be done in the area of expenditure needs.

Looking ahead to 1987, I'm not sure we'll have major problems on equalization then. In 1982, we resolved a period of uncertainty, which went back to 1973, about the treatment of natural-resource revenues. By including them in full and lowering the standard and by bringing in municipal revenues, we were being consistent with the long-term trend in equalization, which goes all the way back to 1957, of bringing in more revenues and lowering the standard.

The present system does have problems. Some are transitional, and they should be resolved by 1986. Others are simply potential – questions about natural resources and the movement of corporate head offices have not so far proved to be significant practical problems. So it is possible that 1987 may not see a lot of changes in equalization. Nobody from the federal government, however, wants to rule out the possibility of further changes. Certainly, they will be carefully examined.

I think one of the major things to watch for those of us who are interested in 1987 is what happens between Ottawa and the governments of Nova Scotia and Newfoundland in regard to offshore resources. Those agreements could well have a bearing on the future direction of the equalization program.

Finally, I want to echo Professor Courchene in paying tribute to what the 'have' provinces have done over the years for the equalization program. We have had enormous co-operation from Saskatchewan, Ontario, Alberta, and British Columbia. Ron McGinley's remarks made evident the very deep interest that the province of Ontario has taken, for example, and I think it has been a very fine thing for Canada.

THOMAS COURCHENE: Just a few comments. Looking just at the formula, Ron McGinley is certainly right that the switch from the 'representative national-average standard' [RNAS] to the 'representative five-province standard' [RFPS] may merely mean that a small province moves from a 95 per cent tax-back rate to a 100 per cent tax-back rate with respect to own-source revenues that are eligible for equalization. The big difference, however, is the fact that *all* resource revenues now enter the formula. Only 50 per cent of

resource revenues were in before, so even if a province had a 95 per cent tax-back rate, this implied an effective rate of only 47.5 per cent for energy revenues. Now 100 per cent of energy revenues are going to be taxed.

If we maintain this formula, look at what is going to happen to Nova Scotia's revenues from offshore resources. We have two choices. One is to do what the formula says, to tax them at 100 per cent. The other is to let the province bring in these rents in a way different from resources – all sorts of dummy corporations could be set up to launder the money. If we tax the revenues at 100 per cent, we've got trouble with our formula, so either way I think it's going to be a big issue. The good thing about it is that off-shore revenues will not come on stream before 1987, so we have a chance to patch up the problem.

To turn to the question of efficiency, what would I do with equalization? If the only issue were efficiency, I suppose I would want an interprovincial revenue-sharing pool. If I couldn't have that, I'd probably slice equalization a bit. But equalization is also a distributional issue, and economists don't have much to say about distribution. I will say this: if we could get rid of the distorting excesses in Unemployment Insurance and other programs, let the market work the way it has to, and focus all our policies on the distribution side, I think we would be doing more for equity than we would by changing the equalization program to make it more consistent with my view of efficiency.

As to what will happen in 1987, one of the advantages of the new equalization formula is that on-shore energy is not going to be as big an issue as it has been in the past. Even if prices happen to increase, the issue has been diffused because Alberta is not part of the standard. However, off-shore energy is now emerging as an issue.

DOUGLAS CLARK: Whatever the specifics of an equalization formula, in order to be fair, it must equalize. The more revenues it includes, the more likely it is to be fair. Thus, a problem with the RNAS-20 formula is that it includes only 20 per cent of natural-resource revenues. On the other hand, the goal of fairness can lead to an attempt to bring in everything, including all transfer payments. I am inclined to think such inclusiveness would put too much of a burden

on the equalization system. I don't think one program can cover everything, though the concept is interesting.

JOHN GRAHAM: I am concerned by the suggestion that if we had an equalization formula, we could dispense with everything else. This is to confuse a vertical and a horizontal fiscal imbalance; established programs financing [EPF] and the Canada Assistance Plan, unlike equalization, provide funds for all provinces, not just the poorer provinces. It is very important to distinguish between these two elements.

CLAUDE FORGET: Professor Courchene, I have difficulty understanding what logical goal you are striving for with this overarching scheme for equalization. Let me illustrate my difficulty by starting from the opposite pole. Assume that the key goal of the fiscal arrangements is the equalization of fiscal capacity and assume the use of an equalization formula much like what we have now except the standard is a national average. Having done that, you have met your equity goals. Then assume that from the total the provinces would receive on equity grounds – which would be about $3 billion more than they receive now – Ottawa would deduct whatever they received under conditional arrangements or block-funding on policy grounds. That intellectual construct is the converse of what you are advocating. But I am not sure what you have achieved either way, except to privilege either the policy function of the fiscal arrangements or the equity formula. How does either relate to current difficulties and the current political debate?

THOMAS COURCHENE: It is very apparent that my notion of having equalization as an overarching program is running into a lot of criticism. Perhaps it is an inappropriate suggestion. However, let me elaborate on it somewhat in order to make more clear what I had in mind. Essentially, it would be a 'representative-expenditure system' approach to equalization rather than the present 'representative tax approach'. As such, it would be motivated in part by the formal wording of the new constitutional provision regarding equalization.

In defining representative expenditures, one would include all provincial expenditures, including the federal shared-cost contributions. One would then adjust these by a province-specific 'needs'

factor in cases where, for example, it might take more dollars per capita to deliver a given level of public services in one province than in another. From this total, one would then subtract a province's 'revenue means', which could be defined as the product of national average tax rates and the province's own tax base. Next, one would have to deduct any federal contributions to the provinces (e.g., EPF transfers) since they have already been included in the representative-expenditure system. If equalization were the overarching program, then these federal deductions would include *all* transfers to the provinces, unless a particular set of payments were specifically designated to be outside of the overall equalization framework.

Under this approach, there would be little point in the provinces arguing that there need be a regional component to every federal-transfer program – the monies would simply reduce equalization. If provinces felt some special need, the place for this to be introduced would be in the representative expenditure system.

To a certain degree, the Australian system reflects this approach. But from the comments I am hearing, perhaps there is less here than meets the eye (or ear)!

DAVID WINCH (McMaster University): I worry about the role of a formula in equalization just as I worry about the so-called formula funding of the Ontario universities. I can see two clean approaches to these and similar exercises. In one, you start with principles. For example, our income-tax system uses the principles that the first so many thousand dollars you earn in a year are yours and that after that you pay one rate on so much and a slightly higher rate on so much, in a set, progressive structure. The indices are adjusted annually, but the tax schedule changes only if it no longer fits the principles, or if the principles change.

The other clean approach is simply to use an arbitrary process. Carving up a provincial budget is a good example. No provincial treasurer says, 'As a matter of principle we will spend *X* per cent of our money on roads and *Y* per cent on parks.' Rather, he comes up with an arbitrary allocation that seems practical.

Each of these approaches is a reasonable, consistent way of allocating money. But what happens in the equalization program? Do you encapsulate some principles in a formula, apply it, and let the

chips fall where they may? If so, you would not be continually revising the formula. Do you simply try to determine a fair, if arbitrary, way of sharing the money? In that case, you don't need a formula. What you actually do, of course, is to spend an enormous amount of time and effort trying numbers this way, indices that way, and measures the other way and then judge the outcome not by the principles on which it is based but by the results. If they are unacceptable – say, because Ontario is eligible for money – you go back and juggle the numbers a bit more. But if you can judge the outcome by the criterion of what is acceptable, it follows that you know what is acceptable, and if you know that, you don't need a formula.

Perhaps the purpose of the formula is to keep civil servants and ministers and academic economists running around in circles generating an enormous smoke screen.

JOHN GRAHAM: While it is true that there has always been an element of compromise in the equalization program, that program, with all its modifications, is still based essentially upon the principle of fiscal equity: namely, that citizens in all parts of the country should enjoy comparable levels of public services with comparable tax burdens.

Furthermore, we are continually grappling with the financial implications of devising and implementing a formula based upon that principle. We have found that to equalize to the revenues of the wealthiest provinces would be beyond the resources of the federal government; hence, equalization has been limited to the national average. We have found that, with the emergence of very large and geographically concentrated oil and natural-gas revenues, full equalization of these revenues would also be financially impossible, even though the principle of fiscal equity calls for their equalization. The current way of dealing with this problem is to base the formula on the five-province average of revenue bases while continuing to use the national average tax rates. Yet such a compromise creates its own problems.

While we shall likely always be faced with having to depart from the principle of fiscal equity, then, that principle remains as the guide and as the standard. Without it as the rationale for equalization, we would be reverting to the earlier jungle of simple political

bargaining. We would no longer have a clear foundation for considering the equity and efficiency bases for equalization, on which the national-unity argument also largely depends.

The mention of principles reminds me of something I would like to ask Tom Courchene about – the cap that's been put on the formula, limiting increases in payments to increases in the GNP. That cap isn't operative at the moment because of the transitional arrangements, but as soon as it is, it will impose a significant departure from the principle of equalization. Isn't this the sort of thing we have to watch for in future revisions of the formula?

THOMAS COURCHENE: We have always had some sort of cap on the equalization program; if it wasn't a resource cap, it was something else. The new program is capped both top and bottom: on the top side by GNP and on the bottom side by the minimum-payment provisions and the transitional guarantees.

While the GNP cap may run afoul of 'full' equalization, it is probably the case that the provinces would not want it removed if it also meant the removal of the lower bounds to equalization payments. This brings me to David Winch's point about the role of the formula as a way to justify whatever sort of result is desired. I think that the 1982 negotiations provided substantial evidence for this, given that one of the goals at that time was to devise a formula that would exclude Ontario as a recipient province. In this sense the formula can become a means of buttressing a set of pre-ordained results. However, one of the key points in my paper is that this approach has backfired: the new program has generated more problems than it has solved.

PART VIII
THE FEDERAL-PROVINCIAL CONSULTATION PROCESS: 1987 AND BEYOND

Federal-provincial fiscal relations: an historical perspective

A.W. Johnson

Federal-provincial fiscal relations have unquestionably become one of the central and continuing dramas in the theatre of federal-provincial and constitutional relations. There may be other performances which have received a higher billing, and certainly there are others which have provided higher drama – the constitutional conferences of 1980 and 1981 being the obvious examples. There also unquestionably have been other performances which have drawn larger audiences, such as, again, the constitutional discussions, and more recently those on the Canada Health Act. But no federal-provincial drama can match in continuity – or, for that matter, in occultness – the drama of federal-provincial fiscal relations. And I have been asked, as a long-time practitioner in the field, to try to give some sense, or some feel, as to how this drama emerged in its present form. Happily, from my point of view, and I hope equally from yours, I have been asked to do this from a personal perspective: as a player of several of the parts in the drama, as it unfolded from 1955 to 1975, and since that time as an unabashedly engrossed observer and critic.

To begin on a personal note, it was just thirty years ago that Ken Taylor, the deputy minister of finance of Canada, invited me, as deputy provincial treasurer of Saskatchewan, to represent the government of that province on a federal-provincial committee of finance officials, which the government of Canada had just authorized him to convene. Its purpose, he said, would be to discuss, at the level of officials, financial relations between the government of Canada and the provinces, and, beyond that, federal-provincial relations as they affected the economy, and vice versa.

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Dr. Taylor, as most of us timorously addressed him at that time, made it clear to me that federal ministers had not come to that decision easily. There were some who had had, and some who still had, serious doubts about creating such a continuing, federal-provincial forum. So we would have to proceed circumspectly, he said, in the evolution and the conduct of the new committee. Dr. Taylor made it clear, too, that the committee would not be a decision-making body, nor would it be one to which federal proposals could be brought before ministers had unveiled them publicly. He was sure we would understand that the role of ministers, and the privacy in which they made their decisions, would have to be respected. What a small committee of officials could usefully do, Dr. Taylor believed, would be to discuss, quietly and informally, emerging issues in the field of federal-provincial relations, and thus hopefully to contribute to a more amicable and thoughtful resolution of the issues when they came before ministers.

Thus was born the Federal-Provincial Continuing Committee on Fiscal and Economic Matters – a name, by the way, which matched in its ambiguity the tentativeness with which it had come into being. Small wonder, indeed: this was a time, and a world, in which federal-provincial institutions scarcely existed. First ministers' conferences, as they now are described, had met only three times since the end of the Second World War. Meetings of program ministers were rare – centering largely on particular questions having to do with the few shared-cost programs which existed – and always they were convened by the federal government. And intergovernmental meetings of officials were virtually unknown, outside of the fields of health and welfare.

This was the environment in which the first major, and continuing, discussions of federal-provincial financial relations were launched. It was a far cry from anything we have come to know or expect today. And if progress is to be measured in terms of the growth of bureaucracies, we have come a long way indeed since that day in 1955!

But it is not my purpose to talk about the federal-provincial-relations industry we have created in Canada, nor how it came to exist. Rather, my purpose is to talk about the substance of federal-provincial fiscal relations and how they came to evolve.

The thing that is most striking about any retrospective look at

federal-provincial fiscal relations is that the subjects which are discussed never seem to change! There are three constants – three subjects – which always are to be found at the heart of the agenda: equalization (of the fiscal capacity of the provincial governments); tax-sharing (the sharing of tax fields between the national government and the governments of the provinces); and shared-cost programs (the use by the government of Canada of conditional grants to induce the provinces to undertake and to maintain certain nationwide programs.)

It doesn't seem to matter how radically the federal-provincial arrangements change, nor over how many watersheds they pass, the debate about these three questions seems to be never ending.

THE EQUALIZATION OF THE FISCAL CAPACITY OF PROVINCIAL GOVERNMENTS

Take equalization as the first case in point. There was, as we all know, a lot of room for discussion and debate in the early days of equalization. In 1955, the year in which the Continuing Committee was established, equalization consisted – to the extent it could be said to exist as such – simply as a part of the old tax-rental agreements. You remember how they worked. The government of Canada 'rented' the personal and corporation tax rights of the provinces – let's forget succession duties in the interest of simplicity – and paid each of the provinces a lump sum in return. Included in that lump sum, for the poorer provinces, was an implicit equalization payment. These provinces, in short, received more money from the government of Canada, in the form of tax-rental payments, than they would have received by imposing their own personal and corporation income taxes – at least at rates which were regarded, at that time, as being 'standard provincial rates.'

This level of payments to the provinces was not all that difficult to achieve when looked at from today's vantage point. For by 1955 the 'provincial share' of corporate and personal income taxes was deemed by the government of Canada to be 7 per cent of the federal personal income tax, and 5 per cent of corporate taxable income. That's what I said, 7 and 5 per cent! And deemed is the right word: the percentages were set by the government of Canada, as the rates at which the provinces would be compensated for renting their income-tax fields (on top of which was 'stacked' any implicit

equalization), and as the rates at which federal taxes would be 'abated' in any province which did not sign a tax-rental agreement.

Now, it mustn't be thought that the provinces accepted these 'standard tax rates' as an appropriate share of the income-tax fields. They did not: and the argument over tax shares increased in acerbity as the postwar financial burdens of the provinces mounted. Indeed, the differences of opinion reached the point where in 1954 Quebec started to impose its own personal income tax, at the much higher rate of 15 per cent – just as that province, along with Ontario, had started to impose its own corporation tax in 1947.

Now there were, as we all know, doctrinal (read 'constitutional') reasons for this action, not just financial ones. Just as there were doctrinal reasons for the government of Canada's desire to retain near-to-full control over income taxation (in this case read for doctrinal 'a fair distribution of tax revenues across Canada'; a reformed national income tax system; *plus* 'Keynesian economic policy'). But the real point to be made, so far as equalization is concerned, is that Quebec by its refusal to enter into tax-rental agreements lost any possibility of receiving equalization payments. For not only were equalization payments an almost unrecognizable part of tax-rental payments; they were *conditional* upon the rental of the income-tax fields!

It seems hard to believe, from today's vantage point, does it not?

Watersheds in equalization arrangements: 1955-7 and 1965-7

Thinking back, it seems to me there have been two or perhaps three major watersheds in equalization arrangements since those days of tax rental. The first of these was during 1955 and on into 1957, when arrangements were developed by the government of Canada to make equalization independent of tax-rental agreements. This was a profoundly important step – on which generated at the time a very considerable debate. I remember, in particular, the arguments that raged among federal officials themselves – most particularly in the homes of Ken Taylor and Ken Eaton (the assistant deputy minister of taxation of those days) – with the latter arguing, most volubly, the case for retaining the tax-rental agreements, and Maurice Lamontagne, the Prime Minister's economic advisor, arguing passionately the case for making equalization unconditional. Bob Bryce, who as secretary to the cabinet knew the mind of the Prime

Minister, Louis St. Laurent, led the way not only in articulating the issues, as he so often did at federal-provincial meetings, but also ultimately, I am sure, in effecting a reconciliation. I recall, too, the basis of the differences – an argument which may seem rather quaint today. It was whether macroeconomic policy and a fair distribution of revenues from a reformed income-tax system depended upon substantial control by the national government over income taxation.

Not surprisingly, given the Prime Minister's personal views, the question was settled on the side being argued by Bob Bryce and Maurice Lamontagne, with the Ministry of Finance coming to accept the PMO-PCO position. And so the government of Canada first approved an unconditional equalization plan. It provided for the equalization of personal and corporate income taxes and succession duties, at 'notional' provincial rates of 10-9-50 per cent respectively, with the standard of equalization being the yield of those provincial taxes in the two 'richest' provinces (the 9 per cent, of course, being 9 per cent of corporate income).

This was an enormous stride: it not only made equalization almost a 'right' of the provinces; it opened the way to equalizing other provincial revenues which were *not* the subject of tax-rental agreements. And this is precisely what happened in the course of the second watershed of equalization – between 1965 and 1967. True, Prime Minister John Diefenbaker did make some adjustments to equalization between 1957 and 1963. He added a special Atlantic Provinces Adjustment Grant, if rather a modest one (1958), and he added a new revenue source to the general equalization formula – namely 50 per cent of natural resources revenues (1962). But it was the 'opening of the doors' of equalization in 1957 which was seized upon by the Ministry of Finance, during 1965 and 1966, for the development of an even more radical formula for equalizing provincial revenues.

The point and the purpose of the new equalization proposal was simple yet sweeping. All provincial revenues would be equalized, not just those selected by the government of Canada. They would be equalized at the rates the provinces themselves had imposed, not at some standard rate chosen by the federal government. And the level of equalization would be such as to guarantee to every province a level of per capita revenue equal to the national average, at national-average provincial tax rates.

The formula, in brief, was comprehensive – it included *all* of the provincial revenue sources. It was responsive to provincial tax needs – it was based upon the actual, or prevailing, *provincial* tax rates. It was automatic – the level of payments varied automatically as a province's fiscal capacity rose or fell. And above all it was objective (a public-service euphemism, by the way, for 'nonpolitical') – it did not lend itself to the arbitrary inclusion or exclusion of particular tax fields.

I am tempted to regale you with stories about the Continuing Committee meetings at which this formula was discussed as an 'hypothetical possibility' (we were still being circumspect, you see). Only this time my stories come from a different perspective. By 1965-6, as some of you know, I was working for Bob Bryce, then the deputy minister of finance of Canada. And I was working for him, and with some fine colleagues in the Ministry of Finance, in developing the new formula. (It was a formula, by the way, which found its origins in some of the work we in Saskatchewan had been doing on equalization during the early 1960s.)

One or two tales I cannot forgo. There was the evening, for example, when Claude Morin and Jacques Parizeau came to my room to tell me they thought a stand-by formula should be developed that would favour the Atlantic provinces more and Quebec less. Why? Because they didn't believe the federal cabinet would ever approve an equalization plan as generous to Quebec as this one was. Why? Because they didn't believe the federal cabinet would ever approve an equalization plan as generous to Quebec as this one was. Then there was the argument over whether we should select each province's own tax rates as the basis for equalizing its revenues, rather than the national-average tax rates as applied in that province. Such an approach would more fully reflect each individual province's tax needs or tax effort, to be sure, but would it hand a bonus to 'socialistic' governments or governments that were simply 'big spenders'? And was it fair to Alberta to include in the formula the proceeds from the sale, or the leasing, of mineral rights – 'capital' as opposed to 'operating' mineral revenues? (None of us, it must be said, was prescient enough to foresee the burgeoning international oil prices about a decade later!)

Not all of the problems were solved, of course: not the question the Atlantic provinces raised as to whether municipal revenues should be equalized as well as the provincial revenues; nor the question

several of the provinces raised as to whether 'equalization' should be given its literal meaning, with the 'equalization standard' being the revenue yield in the top (the 'richest') province, as opposed to the national-average yield. But the product of these two years was a ground-breaking equalization formula – one which a prestigious American publication was later to describe as the best in the world. (No Canadian could make such an utterance, I might say, without adding that, of course, there aren't that many federal countries in the world!)

1982: a third watershed?

But the crossing of these two watersheds – of 1957 and 1967 – remarkable as they may have been, was not the end of the story. An accumulation of problems and pressures, beginning with the first international oil shock in 1973, led to changes in the equalization formula which found their culmination in 1982. And this may well be perceived, in future years, as the third watershed in equalization arrangements in Canada.

The problems which gave rise to the changes are well known. Rising petroleum prices, and energy prices generally, led to the bizarre prospect of Canada's largest 'rich' province, Ontario, qualifying for equalization payments. And this, simply put, would have made no sense at all. So a number of adjustments were tried, all designed to reduce the amount, or the weight, of resource revenues in the equalization formula. In 1982, however, a different approach was found, which addressed itself both to the problem of resource revenues and to the pressure I mentioned earlier for including municipal revenues in the formula. (In 1973, a tentative step had been taken in this latter direction, by the way, through the inclusion in the formula of local school taxes. But it was in 1982 that the decision was taken to include all municipal revenues.)

When taken together, the decision, or the imperative, to make these two changes in equalization opened the door to, or evoked, major adjustments in the formula. And major is the word for the changes which were made. First, the 'reach' of the formula – its comprehensiveness – was once again extended to embrace the *whole* of resource revenues, and, for the first time, the *whole* of municipal revenues. Second, the 'standard' of equalization, or 'level' as it had been called, was changed – from the per capita yield of provincial

revenues in all provinces (with resource revenues especially adjusted), to the yield of all provincial and municipal revenues in five designated provinces. These provinces, as you know, were the five provinces between the richest (Alberta) and the poorest (the four Atlantic provinces).

In essence, this new approach to equalization substituted a 'representative average' for the 'national average'. You drop the extremes – the richest and the poorest – and you get a 'representative measure' of provincial tax capacity in Canada. So the argument went. It's like the scoring system at many international sports meets: you drop the extreme scores, at the top and the bottom, and average those in between. This, indeed – at least so corridor gossip has it – is precisely where the idea came from: it was Gerard Veilleux, today's secretary to the cabinet on federal-provincial relations, who, while watching a figure-skating championship on TV, developed the idea. Thus are public-policy innovations born!

The real question, of course, is how durable this new approach will be: whether the 'representative average' will continue to be accepted as a reasonable proxy for the 'national average'. For today, I perceive no real problem. The experts understand the new formula and the rationale which lies behind it; and the average person, I suspect, still thinks provincial revenues *are* being equalized to the national average – if he/she thinks about the question at all! But it will be for future economists and retired public servants to determine whether this latest change in equalization arrangements represents a third – and lasting – watershed in federal-provincial financing arrangements.

THE SHARING OF THE INCOME-TAX FIELDS

Threading its way through the equalization story and, for many years, an integral part of it, was the closely related saga of tax-sharing. Now, tax-sharing is as central to fiscal relations as is equalization; in some ways it has played an even more robust part in the federal-provincial drama. But it is an issue which is different in character to equalization – in my view, at least – and one which has, as a result, generated a different quality and kind of federal-provincial dynamic.

Let me try and clarify the point. The equalization of provincial revenues has a clear national purpose and indeed even a personal one: to assure to all Canadians, in whatever province they live, a

reasonably equal, or at the very least, an adequate level of provincial public services. And governments, both federal and provincial, have thought and have talked of equalization in these terms.

Tax-sharing, on the other hand, is very much more an argument *between governments*. The question at issue, in plain words, is whether one order of government or another is 'hogging' more than its fair share of the total revenues which are assumed to be available to governments (at a given point in time), and therefore rendering it difficult for the other order of government to raise the taxes it needs to do its job.

Beyond this question there lie two others, both of them as difficult as the first, if not more. First, who is to say – who is to be the judge – as to whether the services being provided by the government which is alleged to be 'hogging' revenue sources are less important than those which the other order of government wants to introduce? And whatever the answer to this question, who is to say whether the governments which are claiming inadequate revenue sources (by reason of the 'hogging' of these sources by the other order of government) aren't really just seeking to avoid the political pain of raising their own taxes? Why not, indeed, try to get the other order of government to reduce its taxes, in order to make way for increases in yours?

These are the questions which, I concluded over time, really lay at the heart of the issue of tax-sharing. And if I am right, then it is more than self-evident why the debates on this question were more acrimonious than those we were hearing on equalization. For they (the tax-sharing arguments) involve judgements about others: judgements about the importance of what others are seeking to achieve, and judgements about the motives behind the arguments the others are advancing in support of their cause.

Tax rental and the abatement system

Now, I concede that this formulation of the issue of tax-sharing is rather stark. And I concede, in particular, that it is too stark – indeed is too simple – to explain the issue of tax-sharing during the tax-rental years. For during those years – not later, as the developing saga of tax-sharing reveals – it was one government, the government of Canada, which was more or less 'in command' in determining what the provincial share of income taxes would be. It was the

government of Canada which determined the share of the income taxes which would be collected and remitted to those provinces which had entered tax-rental agreements; and it was the government of Canada which determined the level to which federal taxes would be 'abated' in the provinces which had not entered tax-rental agreements.

I am reminding you, in saying this, that the government of Canada had 'made room' for provincial income taxes before 1955 – when my story begins – by way of the 'abatement' system. (It was in 1947 that the corporation tax was 'abated' for nonagreeing provinces, by 5 per cent of corporate taxable income; and in 1954 that the personal income tax was abated by 5 per cent of the federal tax.) And the existence of this (abatement) system was evidence that the government of Canada was coming to respond to the pressures from the provinces – notably Quebec and Ontario – for the federal government to relax its hold on the income-tax fields (thus enabling the provinces to impose their own income taxes).

But even under these abatement arrangements, the freedom of the nonagreeing provinces to strike out on their own and impose whatever levels of income taxes they chose was in reality quite limited. First, any province which chose to impose its own income taxes at rates higher than the federally determined 'standard provincial rates' was quickly accused of 'double taxation' – a formidable taboo in the 1950s. Second, and even more fundamental in principle and in consequence, the province which imposed its own income taxes would, as we have seen, lose any entitlement it might have had to the equalization payments implicit in tax-rental payments. Only when these two elements of the tax-rental, or tax-sharing, arrangements were removed – the tying of equalization to tax-rental agreements, and the determination by the government of Canada of the share of the income-tax fields which would be declared to be provincial – would the provinces *really* be free to impose their own income taxes, at rates of their own choosing.

And this is essentially what did happen in the decade between 1957 and 1967. To say it this way is to make it sound easy – which was far from the case. In fact, the changes which were made were radical and tortuous in the perspective of the times. And they emerged not in one fell swoop but over three major intervals.

The changes of 1957

The first watershed came in 1957, when two major changes were made in the tax-rental arrangements. First, the 'standard rates' of the income taxes which were deemed to be provincial were substantially increased: from 5 to 10 per cent on the personal income tax side, and from 7 to 9 per cent on the corporate tax side. And, second, the equalization payments, as I have said, were made unconditional.

Taken together, these two changes dramatically increased the freedom of the provinces to impose their own taxes. But conversely, they dramatically reduced the incentive for provinces to enter tax-rental agreements – or so it seemed at the time to the advocates of tax rental. And that raised the spectre not only of a gradual disintegration of what had become a truly national income-tax system, but also of a gradual erosion of federal control over income taxation. And if that were to be carried too far, the ability of the national government to discharge its function of economic management and to fairly distribute income-tax revenues across the whole of the country would also be eroded. At least so it was argued.

I well recall my premier of that day, Tommy Douglas of Saskatchewan, expressing his deep apprehension that, by these changes, the national government was giving up – at least seriously eroding – its ability to act as a national government. It, and it alone, was able to manage the economy so as to achieve the high and stable levels of employment it had promised in 1945. It alone was in a position to equalize – nay, enrich and extend – the health and social-security measures which the provinces had the constitutional power to enact. To weaken the fiscal capacity of the government of Canada, as these new arrangements could well do over time, would be to weaken the ability of the national government to fulfil these national responsibilities. So said Premier Douglas of Saskatchewan.

His apprehensions were shared by many economists, as I recall. They saw that to erode a nation's capacity to use macroeconomic policy to achieve high, stable levels of employment would weaken the national economy and even, indeed, the nation itself. It was a foreboding, by the way, which has a familiar ring today, as we witness the erosion of the nation's ability to use macroeconomic policy to stimulate employment without the risk of exacerbating inflationary pressures. But the foreboding of the 1950s had a different foundation: the fear that too small a federal share of

income taxes would weaken the *capacity* of the government of Canada to stimulate the economy and to distribute fairly the benefits of economic growth.

This foreboding of 1955-7 turned out to have been exaggerated. For none of the provinces changed their status in respect of the tax-rental agreements. And the federal share of income-tax revenues remained quite large enough for the national government to exercise its macroeconomic responsibilities.

Tax-collection agreements: 1962

What is more, this situation remained intact when the government of Canada advanced still further down the road to provincial fiscal autonomy in 1962 – the second major watershed in tax-sharing arrangements. This was the year in which the government of Canada abandoned the tax-rental agreements, and substituted instead the tax-collection agreements as we know them today. Under the new arrangements, the government of Canada *invited* the provinces to impose their own income taxes, and offered to collect their taxes for them, providing they met one condition: that their provincial tax laws conform with a model income-tax act drafted by the government of Canada. Beyond this, the provinces were free to levy whatever tax rates they chose, subject only to the knowledge that they likely, again, would be charged with 'double taxation'. For the federal Income Tax Act still contained references to 'standard provincial income tax rates'.

Again, all the provinces, except Quebec, entered into the new tax-collection agreements. There were, of course, very substantial incentives for so doing. There was the collection by the government of Canada of provincial income taxes free of charge, and free of the troubles of tax collection and interpretation – troubles we have had occasion to learn more about today. And there was still, as I have said, the hazard that higher-than-'standard' rates of income taxation would invite the accusation of 'double taxation'.

Looking back at these changes of 1962, one can't help but observe that the effect of retaining the notion of 'standard provincial income tax rates' was to perpetuate the argument over tax-sharing – despite the fact that the government of Canada was now proposing to collect provincially imposed income taxes at whatever rates the provinces chose.

But this was not the only petard on which the government of Canada found itself hoisted. The other was the fact that the equalization formula continued to be based on the 'standard provincial income tax rates'! Thus if the poorer provinces wanted an increase in equalization, they had to argue for an increase in the provincial 'tax share'. And if the richer provinces wanted an increase in their income-tax revenues, their best case was to argue that the federal government should reduce its income-tax share.

So the tax-sharing argument continued, unabated, with the provinces arguing that the 'provincial share' of income taxes should be raised (and the 'federal share' lowered), rather than simply proceeding to raise their own income-tax rates. What is more, the argument of the provinces that they needed more 'tax room' acquired an added legitimacy during the 1960s, as a welter of new health-care and social-security measures were introduced. And to make matters worse for the government of Canada, most of the programs introduced – hospital insurance, medicare, and the Canada Assistance Plan – were the products of *federal* initiatives, via shared-cost agreements, with the provinces having to pick up half the tab!

Not surprisingly, this confluence of federal-provincial actions and arguments led to a substantial weakening in the federal government's resolve to maintain its existing income-tax share. And during the first half of the 1960s there was a series of significant abatements in that governments' portion of the personal income tax. It began with Prime Minister Diefenbaker's undertaking, in 1961, to raise the personal income-tax abatement to 13 per cent, and then, during the second watershed of changes in 1962, to raise it again, first to 16 per cent, and then by an additional one per cent per year until it reached 20 per cent. Then Prime Minister Lester B. Pearson, when he assumed office in 1963, faced as he was by the federal-provincial turmoil surrounding his introduction of the Canada Pension Plan, undertook to raise still again the personal income-tax abatement. This time the increase was a further 4 per cent, introduced in two stages, bringing the total abatement to 24 per cent. Think of these changes: from 7 per cent in 1955 to 24 per cent in 1967!

During those years, whatever one's judgement about the rights and the wrongs of such abrupt and apparently unplanned fiscal moves, one conclusion was inescapably self-evident: the government

of Canada was out of control on the fiscal-relations front. And major changes simply had to be made.

The Tax Structure Committee

The story of the changes which in fact came about have in part been recounted, particularly in relation to the equalization formula. But the heart of the changes, insofar as tax-sharing arrangements were concerned, lay in the severance of equalization from any federally legislated provincial income-tax share. This was achieved by two quite simple changes in federal policy. The first, as I have already recounted, was to equalize all provincial revenues, including income-tax revenues, on the basis of actual *provincial* tax rates – the rates the provinces themselves had, in the aggregate, imposed. No longer would any federally determined, provincial tax share be relevant to the determination of equalization payments to the provinces. The second change proposed by the government of Canada reinforced the first: it was to eliminate from the Income Tax Act of Canada any reference to 'standard rates' of personal income tax. The fact that this change was not actually legislated until 1972 does not, in my view, diminish the fact that the case for continuing the argument over 'tax-shares' had been seriously undermined. For these two changes in policy, taken together, permitted the government of Canada to assert – as they did indeed do – that henceforth *all* provinces would have sufficient fiscal capacity to finance whatever level of expenditures they chose to assume. For the provinces would be free to impose whatever tax rates they chose, and the poorer provinces would be guaranteed adequate revenues, at national-average provincial tax rates, under the new equalization formula.

The changes, as I recount them, may seem straightforward today. But not so in 1966, as I have very personal reason to recall. They seemed contrary not only to the conventional wisdom of tax-sharing of those days but also to the joint federal-provincial efforts which by 1964 had been set in train. I refer, of course, to the work of the Tax Structure Committee – a federal-provincial committee of ministers of finance created in 1964 for the purpose of seeking a more harmonious solution to the acute tensions which had developed in federal-provincial relations. (This was the committee which was established, you will recall, at the disastrously divisive first ministers' conference in Quebec City of that year.)

There is a purpose in my saying that I have personal reasons for recalling the dissensions which emerged from these new federal policies on equalization and tax-sharing. For by this time – 1964 – I was both an assistant deputy minister to Bob Bryce, advising on federal-provincial financial arrangements, *and*, at the same time, secretary to the federal-provincial Tax Structure Committee – nominated, in fact, by Jean Lesage, the prime minister of Quebec. And as such I was in the middle of a quite unique experiment in what has come to be known as executive federalism.

I shall not attempt to recall to you the story of this committee, fascinating as it may be. I shall simply say that the burden of its work, undertaken at the behest of the ministers of finance, and performed by the very same Continuing Committee on Fiscal and Economic Matters along with the new federal-provincial secretariat, was to attempt to project the relative fiscal requirements of the federal and provincial governments over the next five years.

This involved, needless to say, projecting the revenues and expenditures of each government in Canada, and determining the shortfall, or the deficit, of each. Out of this it would be possible to determine the relative fiscal requirements, over time, of the two orders of governments.

Now, there were two ways of looking at this joint federal-provincial endeavour. One was that its purpose was to arrive at a common factual base, upon which each government might develop its own views and own policies, for presentation and discussion at future federal-provincial meetings. The other was that the purpose of the exercise was not only to develop a common factual base, but actually to negotiate, at the Tax Structure Committee, an agreed federal-provincial policy.

The provinces, as I perceive it, took the second view of the work of the Tax Structure Committee and its secretariat. And because the fiscal projections clearly revealed that the relative shortfall, or deficits anticipated by the provinces, exceeded the projected deficit of the government of Canada, the provinces fully expected that the Tax Structure Committee would negotiate a transfer of fiscal resources from the federal to the provincial governments. And that meant more 'tax room', in addition, of course, to the new approach to equalization.

But the minister of finance of Canada took the other view of the

joint federal-provincial exercise. To Mitchell Sharp, the projections provided a foundation upon which to base a fundamental review of prevailing federal policies with respect to tax-sharing and equalization. And the conclusions he reached from this review were diametrically opposed to those expected by the provinces.

If provincial expenditures were to rise as rapidly as projected, he said, the only sensible thing to do would be to put the provinces in a position of being able *themselves* to raise the taxes they required. No deficit-sharing for Mitchell Sharp: let he who spends, tax, was his doctrine! Only in this way could *any* government responsibly decide on the future expenditures it should or would undertake. What is more, reasoned Mr. Sharp, the new equalization formula would make it possible for all provinces to raise their own revenues, without resorting to excessive tax rates. For each of the provinces would be guaranteed revenues at the national average of provincial tax yields.

But provincial ministers had not even remotely conceived of the possibility that the minister of finance would reach such a conclusion – perhaps because they had not understood the full import of the equalization formula. But then neither did provincial officials, who *did* understand the formula, seem to have the faintest idea that the Tax Structure Committee's studies might lead to any other conclusion than the one they had reached.

The result is well known: surprise and resentment, on the part of the provinces, over the fiscal proposals advanced by Finance Minister Mitchell Sharp in September 1966. It was not for some months, I believe, that the provinces which qualified for equalization under the new formula came fully to appreciate its significance; and it was much later still that the acute differences over Mr. Sharp's doctrine concerning tax-sharing – 'let he who spends, tax' – began to abate. But the way was nonetheless paved to an entirely new approach to tax-sharing: each government would be responsible for imposing its own taxes – with the revenues of the poorer provinces being equalized, as I have said, to the national average. The objective, now, would be to harmonize federal and provincial fiscal actions in the interests of the economy and the taxpayers – a *genuinely* joint responsibility.

But I mustn't go on too long about the Tax Structure Committee. I have done so, I suppose, because it was the first major experiment in executive federalism, and because I had such personal occasion to

observe it in action. And I have to tell you that in retrospect, on the basis of this experience – plus my 25 years in federal-provincial relations, on both the federal and provincial 'sides' – I do not believe that executive federalism, literally defined, can ever work. Executive federalism in terms of *consultations* between federal and provincial governments: yes. But executive federalism in terms of federal-provincial *decisions* on the policies of governments, or on their execution: no. In the final analysis, each government, each legislative body, must answer to its own constituency. The national government may try to influence the provinces, and properly so, and the provincial governments may seek to influence the federal government, and properly so. But there is no way that either can divest itself of its responsibility to its own legislature and public, in favour of a nonelected, nonresponsible, federal-provincial body. In short, federalism and confederalism cannot coexist.

Subsequent events

But I must not stray too far into conclusions. That will come later. For now let me simply say, by way of concluding my ruminations about tax-sharing, that it is my sense of the events of the last 20 years that there have been no further real watersheds in tax-sharing arrangements (since 1965-67). There was, to be sure, the review of income-tax policy which occurred after the remarkable Report of the Royal Commission on Taxation had been received in 1967 – a review which involved a very considerable measure of consultation between the federal government and the provinces. But the review did not lead to substantial changes in the tax-sharing/tax-collection arrangements as such, despite the watershed character of the tax-policy review itself. There were, I acknowledge, some aftereffects of the federal-provincial consultations of those years – for example, Finance Minister John Turner's decision, in 1974, to administer provincially enacted tax credits under the tax-collection agreements. But this decision tended to entrench, not to reverse, the proposition that each of the provinces and the federal government should take responsibility for its own tax laws.

The same 'no watershed' case could be made concerning the subsequent efforts to seek a consitutional answer to the issue of tax-sharing. I am speaking, of course, of the 'first constitutional review' during 1968-71. In the course of this intensive federal-provincial

examination of constitutional arrangements, both the federal government and the provinces agreed to advance 'propositions' as to what changes they believed might usefully be considered in the distribution of powers – including the powers of taxation. It has to be said, once again, that some extremely useful work was done. But the ministers tired quickly of an exercise which many of them regarded as being too theoretical – as again I have personal reason to recall. One of my most vivid recollections – this time from my vantage point as an advisor to the Prime Minister on the Constitution – is of Premier Ross Thatcher, of my native Saskatchewan, saying that if he had 100 priorities, a review of the Constitution would be his 101st! An extreme position, perhaps, but reflective I believe of the desire of ministers to return to the 'real problems', as they called them, and to political as opposed to constitutional solutions.

So, of this period of discussions concerning constitutional roles in taxation, as of the discussions during the tax-policy review, it has to be said that no watershed was crossed. The arrangements of 1967 remained in place. Not that the question of tax-sharing was finally settled – God knows it was not. But at least it can be said that the *subject*, and perhaps even the participants, were exhausted.

SHARED-COST PROGRAMS

The same cannot be said about the issue of shared-cost programs – the third principal issue of federal-provincial fiscal arrangements. Here is an issue which has remained very much alive as ministers and governments have moved through a series of sharply different, sometimes contradictory approaches to conditional grants.

In essence, I believe, we have gone through three major watersheds in shared-cost agreements, or programs, and may now be moving on to a fourth.

The growth of shared-cost programs: 1955-68

The first such watershed was the mushrooming of shared-cost programs during the period of 1955-68. Now there were, we all know, a number of such programs before 1955: the Technical and Vocational Training Program, begun in 1919; the Old Age Pensions Program of 1928; the Trans-Canada Highway Agreement of the 1950s; and the series of social-assistance programs, first for the 65- to

70-year-olds, and then for the blind and the disabled, between 1952 and 1955.

All of these programs – and indeed others – were extremely important in the social and economic life of the country. And all of them, sometimes singly, sometimes taken together, were at one time or another the subject of federal-provincial controversy. Insofar as Quebec was concerned, it is well known the general reaction to conditional grants was one of hostility and rejection.

But it was between 1955 and 1968 that shared-cost programs came to occupy a central place in the arena of federal-provincial relations. Later, they came to assume a similarly important place in the social life of the country.

First came the Unemployment Assistance Agreement of 1955, a program which for the first time generalized the concept of social assistance to all who were unable to find work (after Unemployment Insurance benefits had been exhausted). This program, combined with the programs for the blind and disabled, led to the inauguration in 1966 of the comprehensive Canada Assistance Plan.

Parallel with these developments on the income-security and social-services side of social security came the steps which were being taken to prepare the way for a nationwide hospital-insurance plan. There was first the Health Resources Fund, established in the mid-1950s for the purpose of putting in place the physical and human resources required if hospital insurance were to be effective. This was followed by the Hospital Insurance legislation itself, which would come into effect when a majority of the provinces had agreed to enter the necessary shared-cost agreements. Then in 1958 hospital insurance actually began, when the new Prime Minister, Mr. Diefenbaker, removed from the legislation the requirement of a provincial consensus.

But that was not all. When Prime Minister Pearson assumed office in 1962, there followed a welter of new federal initiatives to establish nationwide programs. There was the Canada Pension Plan, which, more than any other initiative, gave rise to federal-provincial dissension, and, on a similar if somewhat smaller scale, the Adult Occupational Training Program of 1966. Neither of these programs involved conditional grants to the provinces – they were to be legislated and administered by the government of Canada itself. But that did not diminish the intensity of the provincial reaction to them.

These programs were accompanied or followed by two major measures which did involve cost-sharing arrangements. There was the Post-Secondary Education Financing Plan of 1967, introduced by Prime Minister Pearson himself; although not truly a conditional-grant program, it was widely regarded as such. This was followed, in 1968, by medicare, the culmination of the social-security measures which had been signalled, or promised, as far back as 1945 in the Green Book on postwar reconstruction.

The soul-searching years

Each of the shared-cost measures proposed engendered its own opposition in particular quarters on political and ideological grounds. But taken together, and put in the context of the federal measures such as the Canada Pension Plan, they represented such a major federal engagement in areas where the provinces had legislative competence that the provinces coalesced in alarm. The government of Quebec led the way, as was to be expected. For them, this series of measures proved conclusively that the Parliament of Canada, through the use of its spending power, was shaping the social fabric of Quebec in a way that only the government of that province had the right or the constitutional power to do. The other provinces expressed their opposition more in terms of provincial policies and priorities: how could it be said that each province had the power to direct and control its own finances if the government of Canada could so distort the course of provincial budget-making?

I must not leave the impression that every one of these initiatives on the part of the government of Canada was greeted by this same kind of opposition, or that every province always took the same position. Neither must I leave the impression that only during this decade did these sentiments on the part of the provinces begin to emerge. Far from it. Quebec's opposition to shared-cost programs was, as I have said, almost a constant in federal-provincial relations – even though on occasion that province supported the substance of particular measures. And as for the other provinces, their apprehensions were a long time in developing, as provincial ministers of finance saw their budgetary plans disrupted time and again, albeit by measures which their governments were usually very quick to enact.

But the cumulative effect of these federal initiatives was to create the tenor and the tone of provincial reactions much as I have described them, I believe. Remember that all of this was in the context of the growing sense of crisis during the 1960s over Quebec's place in Canada, and of the growing sense of concern on the part of the other provinces that they must understand and, on occasion, support Quebec's opposition to the so-called 'federal incursions'.

This climate gave rise to deep soul-searching on the part of the government of Canada all through the Pearson regime and through much of the Trudeau regime about what role, if any, shared-cost programs should play in the achievement of national policy goals. Whether this period of soul-searching could be described as a major watershed in the use of conditional grants, I'm not sure. But certainly it was a period of turbulence and uncertainty.

The dilemma the government of Canada confronted was quite clear. On the one hand, there was a prevailing belief, certainly in most of English Canada, that it was appropriate and desirable for the Parliament of Canada to assure to all Canadians those public services they regarded as being essential to individual and social well-being. And those services included such measures as pensions, health care, and income security. Moreover, this belief extended to the standard of these services as they were made available in individual provinces: one's birthright as a Canadian, it was said then and I think still is now, should not be materially diminished or attenuated as one moved across the nation.

On the other hand, there existed, in the province of Quebec and in some embryonic measure in certain of the other provinces, a quite opposite view concerning conditional grants. It was, simply put, that the Parliament of Canada had no right, constitutionally or politically, to intervene by the use of its spending power in areas in which only the provinces could legislate. In Quebec, as I have intimated, this point of view assumed social and cultural as well as constitutional dimensions.

The spectre of special status for Quebec

The immediate impetus for resolving this dilemma, during what I have called the soul-searching years, was the statement made by Premier Jean Lesage shortly after his election in 1960: the province of Quebec would never again sign a shared-cost agreement. It would

take advantage of the moneys available under existing agreements, he said, but in future it would not enter into new ones. Thus the government of Canada was forewarned that any new federal-provincial programs would not apply in Quebec; and moreover, that the government of the province would expect to receive, unconditionally, the moneys that would have been paid to Quebec had it entered into such agreements.

What to do? Well, the first reaction of the government of Canada was to try to experiment with the 'opting-out' arrangements which had been proposed by Mr. Lesage. So it was that in 1964 Prime Minister Pearson offered to all provinces an arrangement under which an unconditional fiscal (tax) transfer would be substituted for existing conditional shared-cost payments. The assumption underlying this new method of payment was that programs such as Hospital Insurance had become so well established in the public mind that no province would dare tamper with them or indeed with the attributes of the programs which were the object of federal conditions. So was born the Established Programs (Interim Arrangements) Financing Act of 1964.

Only the government of Quebec took advantage of the federal offer. And this lent credence to the proposition that what was required in federal-provincial arrangements, if the shared-cost dilemma was to be resolved, was a 'special status' for Quebec. And it was this view that was reflected in the meetings which took place to discuss the proposed Established Programs Financing Act. How well I recall the seating arrangements which were made for the meetings by the Privy Council Office's advisor on federal-provincial relations. Facing one another at the centre of a rectangular table were the officials of the governments of Canada and Quebec, and at the sides, on the periphery, were the officials of the other provinces. It was a symbol of the new order which was supported not only by Quebec but by certain of the ministers and officials in the government of Canada.

But it was not an order which others supported. In the Ministry of Finance, for example – I hesitate to name ministers – there was strong opposition to the very notion of special status. In purely practical terms, it was argued, how could one realistically expect that other provinces and not only Quebec wouldn't come to prefer unconditional grants over conditional ones from the federal

treasury? Anyone who knew anything about provincial treasuries would understand that! 'Free' dollars, rather than 'tied' dollars? Of course.

Beyond this very practical question, however, there lay a much deeper, constitutional one. It was the argument being advanced by Pierre Trudeau, the new MP from Quebec, who was to become the Prime Minister's parliamentary secretary. If the province of Quebec were to be exempted from the application of certain of Parliament's laws, how could the MPs from that province expect to participate in Parliament's debates on such laws? Special status for the government and ministers of Quebec would mean inferior status for members of parliament from Quebec! What is more, said Trudeau and his supporters, special status in stages for Quebec could well lead to the separation in stages of that province from Canada.

Out of this argument there emerged a new, almost opposite approach to the resolution of the shared-cost dilemma. It was the one advanced by Minister of Finance Mitchell Sharp at the September 1966 meeting of the Tax Structure Committee – the same meeting at which the new federal policies concerning equalization and tax-sharing were announced. The essence of his proposition was that all of the federal payments in respect of the major shared-cost programs would be converted into tax transfers, and would be made unconditional. And this new regime would apply to all provinces. It would be accompanied, however, by a new kind of requirement: a general federal-provincial agreement which would preserve the principles, or national objectives, of portability and of federal-provincial consultation on program standards. In essence, the special status which had been gained by Quebec would become a general status, to be enjoyed by all of the provinces.

Cost-sharing without agreements

This new approach – or attempt at a new approach – to shared-cost programs was neither totally comprehensive nor entirely free of ambiguity. But before recounting the denouement of this effort to resolve the conditional-grant dilemma, I have to digress to describe yet another approach which was simultaneously being developed – this time to deal with the question of new shared-cost programs. For neither the Established Programs Financing Act nor the Mitchell Sharp proposals dealt with that question. All that had been said by

Mr. Sharp about new, as opposed to established, shared-cost programs was that 'most Canadians will expect the federal government to retain some vehicle for bringing about new country-wide social and economic advances in the future'.[1]

But what new vehicle? This was a question which had to be answered, and had to be answered quickly, if the government of Canada were to realize two of its immediate objectives: first, to establish the nationwide medicare program of which I have spoken, and second, to finance the expansion of Canada's universities and colleges so they could educate the nation's baby-boom population, now of college age.

Once again the dilemma was more than self-evident: how to channel federal funds to the provinces, conditional upon their being used for the purposes intended, but without requiring the provinces actually to sign a shared-cost agreement? This time it was possible to treat the dilemma rather more as a puzzle, for we in the Ministry of Finance knew that Mr. Lesage favoured both medicare and an infusion of funds for postsecondary education.

The solution to the puzzle was, dare I say it, rather ingenious. In the case of postsecondary education, it was proposed that the government of Canada finance 50 per cent of the operating costs of universities and colleges, but that the federal funds should be paid unconditionally to the governments of the provinces. It seemed relatively certain, to the Ministry of Finance at least, that the funds would find their way into the universities and colleges. For if the provinces did not pass them on, and indeed did not 'match' them, the operating expenditures of the postsecondary institutions would decline, thus triggering a decrease in the federal payments to the provinces.

Claude Morin of Quebec, then the deputy minister of intergovernmental affairs in that province, seemed initially to be suspicious of the federal proposal. At least, that was my sense during a day-long meeting of officials in Quebec City. But Arthur Tremblay, then deputy minister of education of Quebec – now Senator Tremblay – saw the proposal in quite straightforward terms: 'Look', he said, 'I have tens of thousands of kids to be educated, and here is the way to do it – without conditions, and without an agreement.'

In the medicare case the proposal was different. Here it was suggested that the conditions which might otherwise attach to a

shared-cost agreement, had such agreements been possible, should be incorporated instead into a federal statute. Former Premier T.C. Douglas was unknowingly the author of this idea, for it was he who in 1959, in Saskatchewan, first enumerated the principles which he believed should obtain in the medicare plan he was developing for that province. Four of these principles were borrowed for inclusion in the federal statute: universality, comprehensiveness, portability, and public administration. And the federal grants for the financing of medicare were to be made to the provinces, on the basis of an understanding with their governments that these principles would be respected. Again, there was no agreement to be signed. When it came to the question as to how Quebec would react, it was Claude Morin this time – at a private meeting we had in 1968 – who saw in these proposals a way for that province to enter medicare.

Thus it was, from a federal point of view – or at least from my perspective of that point of view – that medicare and the financing of postsecondary education were made possible.

The problem of new programs

Despite the solutions for funding postsecondary education and medicare, the general dilemma of shared-cost programs remained unresolved. The proposals made by Mr. Sharp to resolve the dilemma – the generalized 'opting-out' arrangements I have described – were not taken up by the provinces. And thus the potential of this approach to shared-cost programs was not really tested. Not, that is, until 1977.

Before 1977, however – in 1969-70 to be precise – still another attempt was made to resolve the conditional-grant dilemma, this time having to do with new shared-cost programs. It was the proposition put forward by the government of Canada, during the first constitutional review, that new shared-cost agreements could properly be initiated by the national government, provided a consensus for so doing had been reached with the provinces. The formula for the consensus called for the assent of three of the four of Canada's 'regions', with the added provision that the nonagreeing region or province would be compensated for the taxes that the residents of that province had contributed to pay for a program which would not be applicable in that province. But the compensation would not be paid to the government of the province,

as had been proposed in respect of 'established' shared-cost programs; it would be paid to the citizens who had contributed taxes toward the program whose benefits they would not enjoy.

But this proposal, too, fell by the wayside as federal-provincial discussions on the constitutional distribution of legislative power gradually petered out.

Out of all this long story, it will be evident, I believe, why I earlier asserted that the search for a solution to the shared-cost-program dilemma took many roads. And equally it will be evident that the search failed to come to fruition. The proposals which had been made, in particular those made by Mr. Sharp in 1966, simply remained on the table.

The shift to block grants

It was not until 1977 – the third watershed – that the government of Canada returned to the question of conditional grants and shared-cost programs. But it was another impetus which brought the government back to the dilemma of federal-provincial programs – not, I suspect, the desire finally to put into effect the particular approach to the question which had been articulated in 1966. Rather it was the fact that the federal government now was confronted by the very fiscal constraints which had earlier motivated the provinces in their quest for what they saw as the federal largesse.

The federal deficit was large and growing. Expenditures had to be brought under control. And where better to look, to this end, than the open-ended escalation of federal payments to the provinces on account of postsecondary education and health care? And open-ended indeed was the escalation of these now-huge payments: in the case of postsecondary education the payments were tied to the operating expenditures of universities and colleges, and in the case of health care they were tied to the rate of increase in provincial expenditures on medical and hospital care. And both of these 'escalators' of federal payments lay entirely beyond the control of the government of Canada. More than that, the modes of escalation themselves encouraged continuing increases in the expenditures on these two massive public programs. For the money the provinces were spending on health care and postsecondary education were 'fifty cent dollars'.

It was not the first time, it must be said, that the federal govern-

ment had addressed itself to the uncontrollable character of the escalation of these payments. Indeed, in 1972, a ceiling of 15 per cent had been placed on the rate of increase in federal payments for postsecondary education. But by 1977 the time seemed ripe for a 'permanent solution' to the problem – at least so it would appear to me, by then an outside observer.

The solution seemed straightforward. Convert the shared-cost programs into so-called block grants, and determine independently the rate at which the block grants were to be escalated. The effect of such a solution, of course, would be to make the federal contributions totally unconditional. But this seems to have been accepted as a reasonable price for bringing expenditures under control. It might even be, though this I cannot know, that the conversion of the conditional into unconditional grants was seen as a matter of principle, as a kind of fulfilment of the proposals put forward by Mr. Sharp in 1966.

Whatever the case, the federal contributions did become unconditional, and the government of Canada independently established the rate at which its contributions would be escalated – the rate of increase being the GNP, adjusted for population. This escalator, it must be said, reflected the high priority the government of Canada continued to attach to health care and postsecondary education. In effect, the government was declaring that, for its part, it believed the percentage of the GNP being devoted to these programs should not decline. But there was nothing in the new arrangements which would commit the provinces to adopt this same high priority: the federal contributions to the provinces would grow with the GNP regardless of the rate at which provincial expenditures on health and postsecondary education rose.

The problem with block grants

On the face of it, this conversion of shared-cost grants into unconditional block grants was what the government had proposed in 1966: let the established shared-cost programs, along with the federal money contributed for their financing, be taken over entirely by the governments of the provinces. In short, let there be total disengagement on the part of the government of Canada.

But two things, it must be said, seem to have been forgotten by the architects of the Established Programs Financing Act. One was the

intergovernmental agreement which had been proposed in 1966 to ensure insofar as possible the retention of certain basic characteristics of the programs. That agreement, it will be recalled, would have postulated three requirements: that portability of the benefits of the programs across the whole of the country would be maintained; that regular intergovernmental reviews would be conducted of program developments and potential program improvements; and that the government of Canada would continue to provide what was called technical assistance for the purpose of maintaining and improving program standards. No such umbrella agreement was provided for under the 1977 arrangements.

The second thing which seems to have been forgotten about the experience of 1966 and the years which followed was that the transfer of established programs to the provinces did nothing to determine what mechanisms should exist, or should be contemplated, for the establishment of any new federal-provincial programs. True, Prime Minister Pearson had declared, in the heat of the moment at a tense meeting of first ministers, 'There will be no more medicares.' But was that a declaration of policy, and one so binding on future governments that the question of new federal initiatives had forever been closed?

In fact, I suspect, the government of Canada had not thought its way through to such an unequivocal rejection of the shared-cost route – though this is something I obviously cannot know. The reason I say this, however, is that the 'total disengagement' turned out not to be as total as the new arrangements originally seemed to have suggested. First, the identities of the two programs – health care and higher education – were retained in the legislation. Second, the federal ministers continued to 'track' the rates of increase in provincial, as opposed to federal, contributions towards the two programs. And they continued to take no small interest in what they saw as an increasing erosion by the provinces of certain of the guiding principles of the programs – through the sanctioning of hospital-user fees, of extra-billing by doctors, and of increases in university and college fees.

That the disengagement was not really total was not surprising. The politicians in Ottawa were not unaware of the commitment of individual Canadians to the notion that certain public services are essential to social and individual well-being and, therefore, possess

national dimensions.

It is this underlying 'value' of the Canadian public which is leading, I believe, to a new watershed in federal-provincial programs. It may well be that a return to this 'value' on the part of the government of Canada, through the use, once again, of the conditional spending powers, would be inconsistent with the original objectives of the Established Programs Financing Act. And it may well be that the provinces will continue to argue that the Parliament of Canada has no right to establish conditions for payments made to them on account of programs which only their legislatures have the power to enact. But if the Canadian public perceives a national dimension to programs which are partially financed by their national government, the Parliament of Canada will listen. The recently enacted Canada Health Care Act bears testimony to this fact.

SOME PERSONAL CONCLUSIONS

This, in a sense, is a fitting end to my story. For it opens the door to the quite proper question: where do we go from here? After all, an historical perspective may be interesting and entertaining, as I hope this one has been, but its utility lies in what it might tell us about the future. This is not to suggest that an historical perspective – certainly this one in particular – can be looked upon as predictive. It simply is not. But it does raise certain questions and suggest some conclusions which may serve to illuminate the course for the future. And it is to these questions and conclusions which I now address myself.

Fiscal equalization and decentralization: a task completed

As I reflected upon this retrospective of federal-provincial fiscal relations – and I am deeply grateful to the Ontario Economic Council for having brought me to do so – I found myself drawn to two very general conclusions.

The first of these – and it, like the other, is obviously intensely personal – is that the issue of fiscal decentralization and equalization has by now been well addressed in Canada. Indeed, we have gone about as far in this direction as any nation in the world. We should be prepared to turn this page of federal-provincial relations and address ourselves instead to other, more urgent questions – for example, such as how to go about increasing our lagging rate of growth in Canada.

This is not to suggest that there will be no further changes in fiscal arrangements, or that new circumstances will not arise which in fact will require them. But it is to suggest that we can put to one side the notion that there remain to be redressed major deficiencies in provincial fiscal capacity in relation to that of the national government.

The facts speak for themselves. In terms of the sharing of government revenues between the federal government and the provinces, the federal share of the total is now well below that of the provinces and their municipalities. Where 25 years ago the federal share stood at 58 per cent of the total of all government revenues, today it stands at 35.3 per cent (these are National Accounts data, reflecting the distribution of revenues, after transfer payments, for 1957 and 1982). Insofar as the long-disputed income-tax revenues are concerned, the federal share has similarly abated, though not nearly so much. The government of Canada now enjoys 55.4 per cent of personal income tax revenues compared with 70.8 per cent 15 years ago, and 68.8 per cent of corporation tax revenues compared with 73.4 per cent fifteen years ago (both sets of data for 1982 and 1967 respectively).

The story of tax, or fiscal capacity, leads to a similar conclusion. So long as the revenue capacity of each of the provinces was based on the income, property, sales, and resources of that province, the revenues of the poorer provinces were vastly deficient in relation to those of the richer ones. But once these revenues were brought by the federal government to the national average – or very close to it – through equalization, every province could be said, in the round, to have at least a national-average fiscal capacity. And this, it should be noted, is no less than the fiscal capacity of the government of Canada, which is by definition the national or 'national average' fiscal capacity!

Now I know that the story of fiscal capacity is far more complicated than this. In particular, I know that the poorer provinces don't receive equalization on the margin by which their own tax rates exceed national-average provincial tax rates. But they do receive equalization in respect of all resource revenues, and that is a very considerable offset to this 'marginal fiscal deficiency' – if 'fiscal deficiency' it should be called.

And there is more to it than that. It must be remembered that

three of the most expensive of the programs administered by the provinces – medical care, hospital care, and postsecondary education – are financed at least 50 per cent out of fiscal resources which have been provided by the Parliament of Canada. And this obviously means that in most provinces less than 50 per cent of these costs must be financed out of the equalized provincial revenues of which I have been speaking. Further, on top of that, a second tier of equalization was added in 1977 when the fiscal contributions of the Parliament of Canada to these programs were brought to an equal per capita level in all provinces.

This, as I say, is real and extensive fiscal decentralization and equalization. And it should put to rest not just the grievances of the past, but also some of the mythologies which were born of those grievances. Unfortunately, however, both 'die hard'. The argument about the centralization of fiscal resources still rages on in some quarters. As recently as August 1984, for example, the Premier of Quebec spoke of what he called 'the stupid centralization that has been going on [in Canada] for the last 20 years'.[2] And there is the example, as well, of an Atlantic-province premier who continues to assert, in the strongest of terms, the inability of his province to provide an adequate, let alone national-average, level of provincial public services. Now it may be that this has become a kind of federal-provincial rhetoric that is part of the bargaining between federal and provincial politicians. Or it may be that some premiers really believe that equalization means, or should mean, literal equality: that the poor should be as rich as the richest, and the rich should be as poor as the poorest. Whatever the case, the time has come, I believe, to recognize that to perpetuate the argument over the redistribution among governments of our nation's all-too-puny real economic growth is not only to poison federal-provincial relations but also to deflect us from the fundamental question of how to increase that rate of growth.

Nationwide social programs: a task ahead

It may be that this conclusion will seem provocative to some. If so, my second will seem even more so. It is this: that whereas we have made substantial and beneficial progress in fiscal decentralization and equalization, we have made virtually none in the field of shared-cost (or federal-provincial) programs. Worse, we have allowed the

question of the appropriateness of conditional grants as a catalyst for the creation and continuation of nationwide programs in the provincial domain to become a canker in the body of federal-provincial relations.

This situation has arisen not out of neglect – the story I have told surely demonstrates that – but out of failure to face up frankly to the issues involved. Specifically, it has been a grave error, in my view, to defer, without constitutional reflection or reference, to the conventional widsom, emanating first from Quebec and later from certain of the other provinces, that the Parliament of Canada has no right to exercise its spending power in respect of shared-cost programs. For to do so has been to accept, inferentially at least, either that there are no provincial programs which possess national dimensions, or, if there are, to accept without question the proposition that the means for achieving those national dimensions do not and should not lie in the hands of the Parliament of Canada. Neither, in my view, is a supportable proposition.

It is this question of 'national dimension' which lies at the heart of the issue – as I see it at least. Put more elaborately, the question is this: are there, within the provincial constitutional domain, certain policies or programs which are seen by Canadians as being of such transcending value and effect that their existence and availability across the whole of the country can properly be seen as a matter of national importance? And are there integral to such programs certain attributes or characteristics which equally are seen by the people of Canada as being of such importance that they, like the program itself, should apply across the country?

Individual Canadians would, in my view, as I already have said, have little doubt as to the answers to these questions. To them, their rights, or their privileges, in such fundamental matters as health and social security, and language and education, should not be diminished or attenuated as they move across the nation. Thus, in these areas they want certain nationwide programs possessing certain nationwide characteristics, whether the programs are constitutionally enacted by the federal or the provincial governments.

There are many ways of supporting this commonplace proposition intellectually. The economists, for example, speak in their literature of 'externalities' and 'spillovers' and 'free-riders' that demonstrate

the insupportability of the notion that the costs and the benefits of certain public policies can be contained within watertight provincial or local compartments. And their arguments are convincing.

But personally I prefer the more commonplace argument – perhaps *because* of its simplicity and lack of intellectual sophistication. It also appeals to me because it is unencumbered by any trace of vested interest – such as, for example, the political and bureaucratic advantages which automatically accompany large, exclusive, and tightly protected jurisdictions. These are advantages that can distort or can benefit from the more legitimate arguments about national, regional, and cultural integrity. Thus, the commonplace argument needs to be put, partly because it reflects the interests of individual Canadians, not those of the often-competing bureaucracies which govern them.

The other reason for putting the commonplace argument has to do with the place of transcending qualities and characteristics in nation-building – of which Canada-wide programs are but one small, if important, example. The essence of what characterizes nationhood is, after all, the existence – the daily presence – of a wide range of transcending qualities and characteristics which touch the lives of all the peoples of the nation. And in a country such as Canada, because of its newness and its historical choice not to homogenize, we do not share nearly as many transcending characteristics as do the older nations of the world, such as Britain and France. We don't have a long history as a nation; we don't have a nation which is at once a country and a common cultural identity; we don't share a common language; we don't share a rich range of symbols, mythology, or cultural expressions; we scarcely even have shared enemies and menaces! What is more, there are elements of our history and heritage which actually divide us: the Conquest; the Wars and conscription; the regional economic differences (as exemplified by the 'National Policy' versus 'Reciprocity'), and the rest.

So for Canada, the issue of transcending characteristics is no idle question: it goes to the heart of building the nation. And this is why, when we talk about such apparently occult questions as the spending power and shared-cost programs, we must remember we are talking not only about program and jurisdictional issues: we are talking about whether or not we want to reinforce the transcending characteristics which tie this nation together. And if that is our goal –

and surely it must be – then we *must* look to the means by which the national dimensions of particular provincial programs, both present and potential, may be realized.

We know how this objective *was* achieved, in years gone by. The Parliament of Canada used its spending power – its power 'to make grants' – to 'induce' the provinces to undertake major 'national' programs. The device was, and remains, remarkably simple: Parliament undertook to contribute to the cost of such programs, wherever they possessed the requisite 'national characteristics'. And as and when the provinces came to accept the priority of the programs in question – and the priority rose as the cost to the provinces was diminished – the nationwide program with its nationwide characteristics came into being. In an oversimplified sense, the people of Canada were paying, through their national taxes, for the national or transcending purposes they were seeking to realize in the particular provincial programs in question.

Parliament does, of course, have limits on its power to spend: constitutionally, it may not employ this power so as to have the effect of legislating in areas of jurisdiction reserved for the provinces. But precisely where the boundary lies between 'financing' and 'legislating', we don't really know. Paradoxically, we have refrained all the while from using this vehicle in more and more disputed ways to test the constitutional limits of the spending power in the courts.

Instead we have argued, *in the political arena*, both the normative question of whether Parliament *ought* to have the spending power and the legal or constitutional question of whether it *does* have that power under the Constitution as it exists. Our unwillingness to face up to the *real* question has led to the worst of both worlds, in my view. It has muddled the arguments about the rights and wrongs of particular policies with arguments over which government has the right to do what. It has muddled the question of where the interests of the citizen ultimately lie with arguments over the powers and the rights of different sets of politicians and bureaucrats. It has injected the vagaries of daily politics, power, and public personality into issues where transcending national interests are at stake.

It is high time, I am arguing, that we settled the real issue which divides us. It is not, after all, such a difficult question to define – once one accepts the proposition that *some* vehicle must exist by which

particular provincial programs may be brought to serve transcendingly national as well as provincial objectives.

What should this vehicle be? There are two points of view. One is that the Parliament of Canada should and does have the power to achieve those national objectives by the familiar device of financing the establishment and the maintenance by the provinces of nationwide programs. Parliament is, after all, the nationally elected representative of all Canadians and therefore is best able to perceive the 'national interest' which Canadians want to see served – including those inherent in particular programs which only the provinces may enact. Moreover, Parliament is able, through national taxes and grants to the provinces, to finance the 'cost' to the provinces – financial or otherwise – of reflecting in these programs the national dimensions which are seen to be important.

The opposing point of view is that it is the provincial governments, not Parliament, which are the legitimate representatives of the national interest when it comes to the programs which must be provincially enacted. And it is the premiers who should determine, at their annual meetings, which programs should be thought of as possessing national dimensions and which characteristics are important to the realization of those dimensions. The constitutional formulation as to how this vehicle would in fact work has not, so far as I know, been made entirely clear: whether, for example, the interprovincial body involved would be purely 'confederal' and nonelective in character; and whether it would operate on the basis of unanimity rather than majority (there being no obvious way in which sanctions could be applied). But the *essence* of the confederal point of view seems to me to be quite clear.

What really is at stake here, to put the point even more bluntly, is that two quite different views prevail as to the kind of federalism we have, or should have, in Canada. And this raises the question to which the federal and provincial governments ought long ago to have addressed themselves. Should Canadians look to the Parliament of Canada to speak to their interests on issues which are seen to be of national concern, including those touching on matters which lie in the provincial domain (always providing, of course, that provincial legislative competence is not abridged)? Or should Canadians look to two bodies to serve their national interests: one, the Parliament of Canada, to act on matters under federal jurisdiction; and the other, a

confederal body of premiers, to act on matters under provincial jurisdiction?

The answer to this question – as it exists today or might exist in the future – should surely be found in the Constitution. That is the place where our view of our country and the institutions which govern it are and should be defined – not by way of periodic, highly politicized, intergovernmental meetings. If there *is* any doubt as to what the Constitution presently says, then let our elected officials go to the courts as the occasion demands it. If, on the other hand, there is *not* any doubt, but there are elected officials who believe the Constitution should be different, then let those officials propose a constitutional amendment.

This is not, it has curiously become necessary to say, a confrontational proposition. In a country governed by the rule of law, it surely is the only sensible way to proceed when the two orders of government cannot agree as to what the Constitution says concerning their respective legislative and spending powers.

What is more, this constitutional question is, in any event, but one part of the constitutional puzzle which has not yet been – but ought to be – completed. There is a deep-rooted need to deal with the forces which divide us as well as with the potential for reinforcing the transcending characteristics which bring us together. To be more precise, we must find a way to enable Quebec to become a 'signatory' to the Constitution of Canada. At the same time, we must find a way of bringing to Canadians in the West and Atlantic Canada the kind of power within the Parliament of Canada which will cause them to feel that the 'real' power in governing this nation does not always, and finally, reside in the hands of Ontario and Quebec.

If we fail to do these things – if we fail to provide to all Canadians the sense that they enjoy both a place and a share in the governing of the whole of their country – the growing shrillness of the 'isms' of Canada will ultimately erode our sense of nationhood, I greatly fear. The transcending characteristics which bind us together – yes, including the truly 'national' programs of which we have been speaking – will not, I am afraid, be powerful enough to offset the increasing power of the centrifugal forces of 'nationalism' and 'regionalism'.

It is these two 'isms' – the nationalism of Quebec and the regionalism elsewhere – of which I speak. They are both – we all

know it – 'isms' which are *natural* to our country, where the desire for and the imperative of cultural and linguistic and economic integrity, in all the regions of Canada, must compete with the desire for and the imperative of building a true nation. And in their healthy state, the 'isms' lend a vitality and creativity and richness to Canada, as they have done for so long, becoming a positive force in the body politic. But when they deteriorate into an unhealthy state – when they come to be gospels of division, discord, and sometimes even of hate – then it is time to look to the roots of the discontent. And those roots, I believe, are always the same: the fear that the cultural or linguistic or economic interests of any particular region are or may be threatened by the overweaning power of the other parts of the country within the Parliament that governs all of the regions of the country.

It is this kind of equilibrium – in the power and the representation of Canada's regions in the Parliament of Canada – which is essential to the effective governance of Canada. With this equilibrium, and contributing to it, must go the reinforcement of the transcending characteristics and qualities which bind individual Canadians together.

And this, finally, is what federal-provincial fiscal relations are all about: achieving an equilibrium in the potential for both orders of government to contribute to the enrichment of Canada – in both its national and regional aspects – without diminishing one in favour of the other in the doing of it.

NOTES

1 Statement by the Honourable Mitchell Sharp to the September 1966 meeting of the Tax Structure Committee.

2 CBC Radio News, August 19, 1984.

The consultation process: prospects for 1987 and beyond

Rodney Dobell

When the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements reported in August 1981, its first recommendation was that 'prior to future intergovernmental negotiations on fiscal arrangements, Members of Parliament again have a similar opportunity for consultation with the public' (Canada 1981).

Anyone who has not grown up with the peculiar patchwork of symbolism and pragmatism that is federalism in Canada might contemplate that statement with puzzlement. (Indeed, my remarks here may reveal that confusion is not confined to non-Canadians.) The statement refers to 'intergovernmental negotiations' on measures to be incorporated in legislation by a federal government that obviously – at least in some cases – has the power to pass such legislation unilaterally. Moreover, it recommends bringing new players into the negotiating process. The members of the parliament to which the government of the day must bring such legislation for approval are not, of course, normally involved in the meetings of officials that constitute the bulk of 'intergovernmental negotiations', nor, with the exception of a few ministers, are they involved in the meetings of federal and provincial politicians that end them, either by consummating an 'agreement' or acknowledging their breakdown. The proposed 'consultation with the public' would introduce into direct government-to-government discussions both interest groups that have a direct stake in the expenditure programs

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involved and MPs who want to do more than place an automatic seal of approval on a deal hammered out behind closed doors in a process of horse-trading amongst federal and provincial officials.

This process by which interest groups may use the hearings of parliamentary committees as a channel through which to appeal publicly to Ottawa over the heads of provincial governments is one aspect of Canada's evolving consultation process that warrants further examination below. So also is its asymmetry: many individuals and groups urge greater spending on expanded services and only a few spokespersons identify themselves with the case for overall fiscal restraint.

The Task Force also recommended separating the health-care and postsecondary-education components of the fiscal transfer, to enable the separation of deadlines for the negotiation of the conditions governing each. This move, like several others, signaled a process of undoing the 1977 move to block funding of these programs. Even though a return to full cost-sharing or matching grants has not (yet) been accomplished, one encounters frequent references to falling provincial shares of expenditures on established programs, generally mentioned to justify a return to conditionality in federal transfers. The temptation to test everything by the benchmark of 50 per cent cost-sharing appears irresistible.

This paper reflects on what these and other changes may mean for the future. It begins by briefly outlining the last round of federal-provincial negotiations and then sketches the elements of Bill C-3 (The Canada Health Act) and Bill C-12 (An Act to Amend the Federal-Fiscal Arrangements and Established Programs Financing Act, 1977) to give more detail on developments in the federal funding of health care and postsecondary education. The two final sections offer some speculation on the likely context of future negotiations and on possible developments in the process.

THE FISCAL ARRANGEMENTS OF 1982

The 1981-2 process

The outstanding feature of the setting for the negotiations leading up to the 1982 arrangements was, as has frequently been observed, an unprecedented combination of bitterness, expressions of alienation, and division along regional lines. Of course, acrimony and

controversy have hardly been absent from any federal-provincial discussions since Confederation. But until the last round, the biggest fights in the postwar period had been rooted in differences over issues of principle, such as medicare and tax reform, not in regional conflicts.

In the negotiations of 1981, however, most of the substantive debate over equalization, tax harmonization, and established programs financing (EPF) was drowned in the shouting about the National Energy Program and the Constitution. Only towards the end of the year did federal and provincial ministers begin serious joint discussion of fiscal arrangements.

Some provincial ministers still attribute the blame for the late start to an innovation in the process, namely the creation of a parliamentary task force to hold public hearings on the fiscal arrangements in advance of direct government-to-government talks. Appointed early in 1981, the Breau Task Force worked intensively through the spring and early summer; it submitted a substantial report (Canada 1981) in August.

Amongst other measures, the Task Force proposed splitting EPF transfers into separate components for health care and postsecondary education, incidentally exposing thereby the so-called revenue-guarantee component to change. It also urged that the responsible federal ministers consult forcefully with their provincial counterparts to ensure that the transfers achieved 'national' (federal-government) purposes, and that these federal ministers received from provincial administrators the information necessary to account to the House of Commons for the federal resources allocated to established programs. In the case of health care, this accounting would entail development of operational criteria by which programs could be monitored, as well as a graduated holdback of federal transfers to be imposed if necessary. In the case of postsecondary education, the Task Force eschewed legislated standards but urged extensive consultation and detailed reporting. For the Canada Assistance Program (CAP) and, interestingly enough, for equalization, it recommended no specific major changes, and it endorsed continuation of the tax-collection agreements and efforts to promote fiscal harmonization.

In the budget papers of 12 November 1981 and in negotiations during the following four months, the federal government did

indeed pursue the approach the Breau Task Force had urged for the EPF programs, in the process knocking off the top of the transfer cash corresponding to two tax points that had been associated with the 1972 revenue guarantee. It also came up with some interesting proposals on equalization, particularly the idea of an 'Ontario standard' (which would have, in effect, excluded oil and gas revenues as resources to be equalized and at the same time eliminated the necessity for the 'Ontario override' that had ensured that that province could never become a recipient province). Subsequent meetings of the finance and the first ministers scrapped over all these issues and introduced the present 'representative five-province standard' for equalization payments. As the disagreements heightened, the Economic Council of Canada rushed a summary of its consensus document, *Financing Confederation* (ECC, 1982), into the debate, but in the end, no formal federal-provincial agreement could be reached. Bill C-97 (An Act to Amend the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, and to provide for payments to certain provinces) was presented to the House in March 1982 as the product of negotiation and compromise, but not as a five-year agreement. Perhaps symbolically, it was then caught up in protracted ringing of the division bells and squeaked through on 5 April 1982, barely in time to mandate the first round of federal equalization payments.

Bill C-12

Bill C-12, An Act to Amend the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, passed early in 1984, marks the end of the two-year period provided, when the fiscal arrangements were renewed in March 1982, for consultations and discussion of ways of implementing national objectives with respect to postsecondary education. Bill C-12 implements the Breau Task Force's proposal to separate the education and health-care components of the EPF transfer, bringing it in line with the pre-1977 structure. The portion associated with the revenue guarantee having already been knocked off in the budget of 12 November 1981, the separation is accomplished simply by dividing the remaining overall transfer into two components: 67.9 per cent for health care and 32.1 per cent for education.[1] The bill also applies the '6 and 5' limits to the postsecondary-education transfers in 1983 and 1984, thus reducing by

about $260 million the base on which funding will be calculated after 1984/5.

The significance of Bill C-12, however, is that given its separation of EPF into independent health-care and postsecondary-education components, and its lack of a formal federal commitment to the postsecondary-education transfer beyond April 1984, it opens the door for the introduction of conditions designed to promote the achievement of 'national' (federal) objectives or standards in postsecondary education. Moreover, the application of the '6 and 5' limits to education funding can be seen as a demonstration of federal willingness to cap the transfer in one way or another – perhaps eventually by limiting any increase to a matching of provincial increases.

Federal action to limit transfers for postsecondary education is, of course, not new. Soon after introducing the cost-sharing arrangement in 1967, Ottawa so feared a completely nondiscretionary tie to exploding provincial costs that it introduced in 1972 a ceiling of 15 per cent per annum on the growth of federal expenditures for the postsecondary-education transfer.

The subsequent move to block funding in 1977 was apparently viewed by all participants as a further step to encourage still-greater provincial efforts to control expenditures, and to reallocate resources from education, where cost pressures appeared to be slowing, to health care, where they were expected to grow. In the event, paradoxically, provincial measures to bring outlays for postsecondary education down to less than double the federal transfer for that purpose[2] have been widely criticized. They appear to call into question – at least for federal politicians – the adequacy of provincial expenditures in support of postsecondary education and provincial commitments to use the federal transfers for their intended purposes.

The Breau Task Force's emphasis on accountability is also mirrored in an amendment to Bill C-12 introduced by Flora MacDonald. It requires that a regular report by the minister to the House on the achievement of 'national purposes' in education be referred to a standing committee for study.

Bill C-3

Bill C-3, the Canada Health Act, represents the dropping of the other shoe in negotiations concerning established programs financing.

Whereas no explicit performance criteria have ever constrained eligibility for federal transfers for postsecondary education, the Hospital Insurance and Diagnostic Services Act and the Medical Care Act have long established basic conditions for funding hospital and medical insurance – the well-known requirements of public administration, comprehensiveness, universality, portability, and accessibility. The question of enforcement or penalties is, of course, central. The purpose of the Canada Health Act, passed 9 April 1984, is to spell out more precisely what these terms are to mean and thus

> to establish criteria and conditions that must be met before full payment may be made under the Act of 1977 in respect of insured health services and extended health care services provided under provincial law (Section 4).

In particular, to satisfy the criterion of comprehensiveness, a province's health-care insurance plan

> must insure all insured health services provided by hospitals, medical practitioners or dentists, and where the law of the province so permits, similar or additional services rendered by other health care professionals (Section 9).

To satisfy the principle of universality, it

> must entitle one hundred per cent of the insured persons of the province to the insured health services provided for by the plan on uniform terms and conditions (Section 10).

Whether this last phrase excludes medical- or hospital-insurance premiums is not clear to me.

To satisfy the criterion respecting accessibility, a province's insurance plan

> must provide for reasonable compensation for *all* insured health services rendered by medical practitioners or dentists (Section 12(1)(c), emphasis added).

For any province that does not permit extra billing, Ottawa will deem it to have complied with this provision if it has entered into an agreement with medical practitioners and dentists that provides for negotiations on compensation between it and the appropriate provincial professional associations and for the use of conciliation or binding arbitration to settle disputes relating to compensation.

(Many provincial governments appear distinctly unhappy with this push towards binding arbitration.)

If, after consultation, the minister believes that a province's health-care insurance plan fails to meet this criterion, 'the Minister shall refer the matter to the Governor-in-Council' (Section 14(1)). The mandatory process of consultation requires that the minister, before making any such referral, send a notice of concern to the province, seek further information, send a report back to it, and, if requested, meet with its representatives within a reasonable period of time – unless the minister is 'of the opinion that a sufficient time has expired after reasonable efforts to achieve consultation and that consultation will not be achieved' (Section 14(3)).

The Governor-in-Council may, in turn, direct that any cash transfer payable to that province be reduced by 'an amount that the Governor-in-Council considers to be appropriate having regard to the gravity of the default' (Section 15(1)). There is no appeal from such a decision; the only provision for review is that it will not come into force for thirty days after a copy has been sent to the province concerned. During this time, the Governor-in-Council may, by order, repeal or amend the previous order.

Extra billing and user charges do not fall under these provisions relating to general criteria. Separate provisions state explicitly that for a province to qualify for its full cash grant, its health-care insurance plan must not permit any user charges or extra payments for insured services. If a province fails to comply with these two provisions,

> there shall be deducted from the cash contribution to the province an amount that the Minister, on the basis of information provided in accordance with the regulations, determines to have been charged (Section 20)

through extra billing or user charges, as the case may be.

The quality of the current relationship

I go into all this detail simply to suggest the flavour of things as they now stand. If I understand correctly, the current EPF arrangements have no 'sunset' (termination) provision and no provision for notice of negotiating their renewal. There is no necessity of reviewing these

programs every five years – or, indeed, of waiting five years to amend them. The general block-funding arrangements have been unbundled. A cash transfer associated with the revenue guarantee has been knocked off the top.

National criteria for health-care insurance have been spelled out in a manner that provincial governments fear will make it much harder to maintain any control of costs or utilization. The federal government's anxiety about finding some leverage by which to promote national objectives in postsecondary education and its willingness to limit unilaterally its transfers for this area have both been signalled clearly.

The provinces – especially Quebec – see this move from principles to which they were encouraged to adhere towards conditions with which they must comply as inconsistent with the original understandings that brought them into these programs, as Claude Ryan has implied at this conference. The likelihood of resolution through federal withdrawal coupled with further transfers of revenue sources or tax points has been demonstrated, I think, to be small indeed.

Thus, the transfers for established programs financing begin to look less and less like mechanisms of decentralization or devolution that respect provincial jurisdiction, more and more in accord with Robert Stanfield's description of them at this conference as programs 'launched . . . not to help the provincial governments but rather to serve the national objectives it [Ottawa] wished to pursue . . . centralizing in conception and effect'. The goal seems to be a delegation of tasks to the regional delivery system of a hierarchical organization, not a financial arrangement to support a division of powers.

This trend warrants some reflection. We have seen in the last two decades two offers of much more substantial decentralization. A federal proposal to transfer sixteen personal-income-tax points lay on the table throughout the mid-1960s.[3] 'Foundation financing' (an early attempt at block funding) was discussed in the 1972-4 period and led eventually to the established programs financing arrangements of 1977.

The provinces did not take up the offer to transfer tax points, and they actively resisted the 1977 arrangements, which represented the culmination of the federal government's continuing attempts to find

financing arrangements in line with principles of fiscal responsibility. The federal position of the Pearson years, which seems to have envisaged a situation in which tax transfers and equalization payments would eliminate the necessity of conditional grants or shared-cost programs, has now been reversed. Having worked our way up to a test of block funding, we are, it seems, rejecting the results and – in the face of the much stronger and more explicit roles of the provincial governments – turning away from the model of decentralization and devolution.

THE CONTEXT FOR NEGOTIATIONS IN 1987 AND BEYOND

Seeing the foregoing as the situation in which we now stand, I ask myself what sort of context we are likely to have for federal-provincial negotiations in 1987 and beyond. If the 'new realities' Premier Bennett sees from his vantage point in Victoria, looking out on the rest of the world, do characterize the next decade or so, then fiscal restraint will hang heavy over the process of federal-provincial consultation and negotiation. If it is true that we can no longer make our way in the world because we have become uncompetitive and too slow to adapt, and if that situation results from our having built up all manner of social protections (and consequent rigidities) that our competitors lack, then we can expect growing tensions between federal and provincial governments in a struggle to increase revenues and shed responsibilities.

That process will involve more than negotiations between governments. The distributional coalitions that some observers see as the source of our reduced adaptive capacity (and hence reduced income prospects) will be seeking to further their own interests by working through both orders of government. The conflict between real property rights and less tangible social or membership rights cuts across provinces and regions. And it involves a variety of interest groups directly in controversies over federal-provincial tax and transfer arrangements as well as over the more general conditions governing the economic union.

Thus, the first thing one can suggest about the future is that it will involve more examples of the phenomenon noted by the Breau Task Force: the desire of interest groups that are provincially based and operate in areas of provincial jurisdiction to appeal to the federal

government for action (standards, criteria, rules, whatever) to offset the impacts of provincial governments' spending (and legislative) priorities. The prospect is, perhaps, ironical. Conventional wisdom responds to growing government power in cyclic fashion: there is a sense of analyst and academic fleeing from one pole to the other in search of a haven. In the early 1970s, observers outside government and analysts inside, recoiling in apprehensive reaction against the perceived excesses of federal-government growth, repeated the litany of appeal to decentralization and devolution. Now notions of national standards and national institutions are growing again in reaction to the perceived excesses of provincial political leaders posing as the only legitimate representatives of regional interests even within national institutions and in recognition of arguments that the protection of human rights may require appeal to federal institutions.

Thus, the apparatus of the federal government is emerging as a forum in which complex interest-group conflicts will be played out. In place of clashes of federal and provincial interests emphasizing regional alienation, one can foresee both orders of government being used as channels through which other groupings and coalitions will seek resolution of other social and economic conflicts.

It is tempting to speculate, therefore, that federal-provincial clashes will focus increasingly on the competition for revenues, as each order of government is increasingly pressed by the demands of interest groups seeking aid to deal with economic crisis. But the prospects for resource rents and revenues are far less rosy than they were a few years ago. Indeed, the pressure for tax expenditures, concessions, and incentives merely to maintain existing levels of activity in the resource sectors is growing substantially. Some analysts argue that these sectors may have no returns to tax or to equalize after the costs of maintaining the resource base and harvesting the yield are netted out. This growing recognition of reinvestment needs and harvesting costs may entail some substantial changes in the equalization formula.

Another important battle of the next decade will be between the groups seeking greater reliance on market forces and reduced restrictions on the exercise of property rights and those seeking increased insulation from the adverse outcomes of market adjustment and greater exercise of political powers to assure

protection of individual rights on the job, in the marketplace, and in other social institutions. Whatever the outcomes, they can only cost governments money. (Note, for example, Don Rowlatt's comments to this conference on the need for greater expenditures to sustain incomes and work experience during job transitions and transitions from school to work.) The struggle for revenues to pay for these settlements may be the major feature in the next turn of the federal-provincial-relations wheel.

A return to declining real costs of energy, minerals, and other raw materials will, of course, entail a view of the distribution of fiscal capacity across provinces that is quite different from the one that prevailed in the run-up to the last set of fiscal arrangements. The picture in 1981 showed the balance of fiscal capacity in Canada tilting heavily westward, with the Atlantic provinces well below, the central provinces (including Manitoba, for the purposes of this image) at, and the western provinces well above the national average. But that view is now out for revision. Whether one expects to see a response to current problems through an effort to reduce real wages, through an attempt to protect current wage levels and domestic activity, or through a restoration of investment and productivity growth, it seems unlikely that a wave of rising prices for resource exports will bolster the Western provinces' prospects for revenue. Hence, the strains of extreme horizontal imbalance seem unlikely to be so severe in the next round or two.

The pressures from groups seeking protection against the contraction of social programs, as well as the squeeze on government expenditures arising particularly from rising health-care costs, seem to promise a more-than-adequate replacement for the previous regional tensions. Clienteles in every province will urge national standards and principles to sustain what have come to be accepted as reasonable levels in the social safety net and reasonable benchmarks of distributive (and administrative) justice, undermining the provinces' claims to represent the interests of their residents by reflecting local priorities in their own expenditure decisions for and administration of social programs.

Moreoever, let us not overlook the potential of trade policy, job-protection measures, and economic regulation to produce regional conflict along the traditional lines so well described by Roy Romanow in his contribution to this conference. The more recent concerns of

Western premiers – tariff protection and quotas, federal policies to support exchange rates, and industrial policy, for example – will also find continuing expression.

Possible areas of negotiation

What then will the federal and provincial governments have to negotiate in 1987? The unfinished business of equalization includes the treatment of rents, explicit and imputed, the treatment of public enterprises, and the inclusion of the cost of providing public services as a factor in determining equalization payments. Michel Robert's comments at this conference, regarding the way in which Section 36(2) of the Constitution Act, 1982 raises the possibility of provincial governments' bringing suit against the federal government for a failure to live up to the letter of the commitments set out there, suggested fascinating lines for reflection, particularly in light of efforts to incorporate some allowance for differing costs of providing public services. Equally suggestive is the notion that some version of a 'residual' equalization program (netting negative equalization entitlements against other federal transfers) is one way to move towards some vision of an interprovincial or overarching equalization scheme and thus deal more fully than we have with horizontal as well as vertical imbalance. With program expenditures bounded between floors and ceilings on rates of change, some such innovations may look attractive. Greater attention to fiscal-stabilization transfers might also be anticipated next time around, even though the recent unprecedented transfer of $174 million to British Columbia has so far gone almost unnoticed.

On the program side, cost control in health care is bound to figure heavily. One can expect appeals to market mechanisms and the private delivery of public services for two purposes: (1) to regulate choice of technique and thus respond to concerns about overspending and the need to 'spend smarter', as Greg Stoddart suggested to the conference, emphasizing prevention and good practice rather than technology and best practice; and (2) to signal the appropriate scale of services, letting the appearance of severe price rationing sound the alarm on underfunding. The revitalization of national institutions in postsecondary education will also remain on the agenda, and, as Claude Forget indicated to the conference, education for job mobility may be added.

In addition to these possible amendments, one might anticipate moves to break EPF and the CAP fully out of the traditional five-year cycle of forced revisitation and renewed anguish, to permit a period of holding steady, of consolidation and streamlining without any formal sunset clause.

POSSIBLE CONSULTATIVE PROCESSES FOR THE FUTURE

In thinking about the likely economic context of or agenda for future negotiations or the state of relationships in which they will be conducted, we must not fall into the trap of extrapolating from the latest swing of the pendulum or the last blip on the chart. I am not persuaded that the deep economic pessimism of the 'new realities' is either new or warranted in the medium-long run. But it does seem likely that the federal government will be entering its own period of serious fiscal restraint a year or so into the new mandate for whatever party forms it. Provincial governments will still be deeply concerned about avoiding any reductions in the federal transfers that represent a significant proportion of their revenues. For 1987, therefore, the climate seems predictably strained.

Thus, the participants in the next round of discussions will not find it easy to achieve what must be their absolutely first priority: a reduction in the deep and pervasive sense of bitterness and even betrayal felt by provincial ministers and in many cases, it seems, provincial officials. If our governments cannot attain co-operative federalism, they must seek at least a practical federalism. As the Breau Task Force reported, Canadians

> are more concerned with a workable federal system than with fine points of jurisdiction. . . . They would not long tolerate intergovernmental rivalry as a reason for denying the provision of essential services or the resources necessary to ensure all Canadians access to them. (Canada 1981, 6)

In this respect, the citizens may be ahead of their governmental representatives, and tired of the fighting.

How might the fighting be muted? One step is to get started on the problem with adequate time for some serious consultation in good faith. Appointing a parliamentary task force to establish a process of open public consultation beginning in 1985 – as soon as a

new federal government settles down to work after the election – would be consistent with the recommendations of both the Breau Task Force (Canada 1981) and the Economic Council of Canada in its consensus document, *Financing Confederation* (1982). One can speculate about the machinery necessary to give these consultations life as a mixed federal-provincial activity. One valuable idea from the ECC (1982, chap. 10) is to have public-interest groups present their cases at a series of meetings held jointly by members of each provincial legislature and a federal legislative committee.

More substantially, beyond consultations with interest groups, could not such a joint committee produce shared analytical work, with the activities of technical subcommittees leading to documents that would ultimately go on the public record and to an agreed-on data base and analytical foundation that would go to all the federal and provincial ministers concerned? Such a process might lead to negotiations based on explicit discussion of the outlook for underlying economic and social factors. Conscious effort to feed the work of the Macdonald Commission and its staff into this process might even result in greater convergence of views as to the framework within which negotiated outcomes must be constrained.

All of this sounds a little like re-inventing the famous – and persuasive – Tax Structure Committee or the Continuing Committee of Officials with a broader mandate. And indeed, much of the purpose would to be work back towards the sense of mutual involvement and responsibility that seems to have characterized that exercise in the early days.[4]

These suggestions imply no reflection on the work of the continuing federal-provincial committee, but I would argue for the more open process. In this field, despite some cynical commentary to the contrary, the task is not just finding a formula that fits or rationalizes a desired outcome. One must test alternative possible principles by examination of their consquences; one doesn't know what is acceptable until it is tried. And for this purpose, an open process involving politicians is the most effective forum.

This forum could consider three procedural changes that would reflect recent evolution in our views as to the way public policy is formed:

1 The process of serious technical and 'rational' analysis of an effi-

cient allocation of a fiscal dividend should be substantially augmented – perhaps dominated – by consultations designed to determine an *acceptable* distribution of the burdens and costs of economic adjustment and retrenchment. That is, the identification of an acceptable compromise would be a conscious focus of an exercise shaped by technical analysis only so far as necessary to determine a feasible domain of discourse. The issue is fundamentally political (in the best sense of that word), not analytical, though analysis is necessary to set some reasonable boundaries.

2 The committee should look for help in the growing new literature on analytical methods to support negotiations. 'Plural rationality', 'interactive decision-support systems', and 'multiperson multiobjective decision processes' are among the labels used to describe a body of techniques purporting to help participants in a negotiating process achieve satisfactory outcomes. Strong staff support to the task force suggested above might permit some appeal to such machinery, at least in some elements of future negotiations. (M. Forget's proposals for careful analysis of alternative financing arrangements in postsecondary education might qualify as one example here.)

The focus of these techniques is on the identification and reconciliation of differing perceptions, outlooks, and expectations in negotiations. Where such differences persist, they may, in themselves, suggest scope for mutually satisfactory outcomes.

3 Finally, the committee could step completely outside the traditional structure of federal-provincial negotiations. Norman Spector, deputy minister to the premier of British Columbia, in a speech (1984) to the Montreal chapter of the Institute of Public Administration of Canada (IPAC) pointed out that the machinery of conflict resolution in labour relations might suggest some possibilities for federal-provincial relations.[5]

It is not clear to whom or what one might appeal for mediation, conciliation, or arbitration by final-offer selection in the field of federal-provincial negotiations. But one thing is clear: we will have achieved significant progress when federal and provincial politicians all recognize what is axiomatic in labour relations – that however much interests conflict in the short run, we have only shared stakes in the survival of the system in the longer run, and whatever deal can be

forced on some today, not too far into the future we all have to meet around the same table to cut another deal, in different circumstances, with different distributions of leverage, but with the same shared interests.

There are, of course, problems in reconciling the need for flexibility and adaptability in federal-provincial negotiations with the need for a degree of stability and predictability. Labour relations' machinery for conflict resolution might impose too much pressure towards detail and precision in arrangements that ideally should remain a little loose and subject to adjustment. On the other hand, the key feature of such machinery is surely underlying tolerance. Apart from the inevitable playing to the galleries or posturing for the media, the expectation is that parties can meet around the table with different views and differing interests and still recognize that they must emerge with a workable agreement. Even though the federal government ultimately passes the legislation, federal-provincial consultations must be considered in some sense a negotiation process in which consensus is not simply a luxury.

Perhaps it is significant that in the 1976/7 discussions of the federal-provincial fiscal arrangements there was a commitment to establish agreement, a need for negotiation and for concessions on both sides because the provinces had a degree of leverage. In 1981/2, there was a willingness to accept the breakdown of discussions, perhaps partly because relationships had broken down so badly elsewhere in the federal-provincial arena. In any case, some of the ground rules of negotiation processes and conflict resolution, if not the precise institutions of collective bargaining, are worth remember-ing in thinking about the next round of federal-provincial discussions.

The consequences of these changes in structure could be substantial. Placing discussion within a task-force mode of consultation would lead not only to a different process, but to the likelihood of a different type of outcome. Although the expected tenure of federal and provincial ministers and even perhaps senior government officials may be shorter than that of labour negotiators, their time horizons for policy purposes must be at least as long. An increased focus on the democratic criterion of public acceptability would mean less likelihood of a stalemate amongst contending, equally persuasive rational positions and more emphasis on cutting some acceptable

deal in order to get on with the action. In federal-provincial relations, I suspect this change is what Dr. Spector meant, and I am sure it's what the people want. It would also help to offset the impression that executive federalism means inferior roles for members of legislatures, federal or provincial.

Perhaps the idea of a task force can be cast as an idea for a process that encourages pulling together and getting on with the job in the face of an economic crisis. Or perhaps it is merely common sense. In any case, it's worth some thought as to what procedures or analytical machinery could be used to develop this approach for the coming rounds of the federal-provincial negotiating process. In other words, the parliamentary task force seems to me to have proved its value as a way of opening up the process of executive federalism and a way of ensuring that the underlying political judgements on acceptable action are fully explored and ultimately dominate the bureaucratic and analytical debate.

A task force is, however, only a mechanism for aiming at a goal. Whether it is exactly the right machinery for the process next time around, the need to seek greater public awareness of the process and the stakes seems clear. Tolerance and civility in the face of diverse views are not mere cosmetics in this process; consensus is not a luxury affordable only when times are rosy. Achieving reasonable consensus on the issues discussed here will be a test, and we should begin searching early. Indeed, perhaps the beginning of wisdom is to see the matter not as a comprehensive quinquennial negotiation amongst rival factions but as a continuing practical adaptation within a joint enterprise.

NOTES

1 These being the respective shares in the 1975/6 base year used to calculate the per capita entitlements for each province under the 1977 arrangements; they are probably now substantially out of date, though the data necessary to confirm this contention are no longer available.

2 As calculated by the federal government, including the so-called tax transfer.

3 It was withdrawn to make way for negotiations on tax reform.

4 I was a little taken aback to hear Al Johnson's observation to the conference that the Continuing Committee foundered because the provincial representatives' expectations and perceptions differed so greatly from those of Mitchell Sharp, then incoming federal minister of finance. Perhaps the moral is that technical analysis could make a considerable contribution to reconciling different perceptions of what is feasible.

5 Among other things, the labour-relations model suggests value in less, rather than more, integration of cost-sharing programs, the delivery of services and tax-sharing arrangements, the distribution of revenues, and equalization payments. One massive package may create more problems than benefits. Yet, broadly interpreted, Section 36 of the Constitution Act, 1982 would embrace all services, including those financed under EPF, and hence very broad integrated negotiations. Indeed, I suppose it is possible that broad judicial interpretation of Section 36 might lead to such an expansion as to take over all shared-cost programs and thus realize Pearson's 1964 goal of providing all the resources necessary to achieve full federal withdrawal from the fields of provincial jurisdiction. And this expansion would occur just at the time when the federal government seems to have concluded that withdrawal is not acceptable, that the nationhood arguments Tom Courchene recalled at the opening of the conference must prevail and be actively pursued. The machinery of equalization necessary to permit this degree of decentralization, however, is not easy to envisage.

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First ministers' conferences in the Canadian federal system

J. Peter Meekison

The Federal-Provincial Conference of First Ministers on the Economy, held in February 1982, was a failure of classic proportions. It came at a time when federal-provincial relations were at an all-time low. Governments were exhausted from years of constitutional debate; Quebec was isolated from the other ten; the economy was sliding into a recession; and the federal government, in its November 1981 budget, had announced major revisions in the fiscal arrangements, changing the rules in the middle of the game. Any one of these ingredients would probably have contributed to an unsuccessful conference. Their combination was a recipe for a failure that has partially discredited the consultative process, raising questions about its future. Fortunately, such a combination of adverse forces seems unlikely to be repeated, and first ministers' conferences will remain an important part of the Canadian federal system.

Their spirit must, however, be revived as part of the cure for the current unhealthy state of federal-provincial relations. One of the important themes in the Macdonald Commission's preliminary report, *Challenges and Choices* (Royal Commission on the Economic Union and Development Prospects for Canada 1984), is the need for harmonization of intergovernmental relations, replacing the discord characteristic of the past few years. If we accept the Macdonald Commission's challenge, we must devise more effective mechanisms for federal-provincial consultation.

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What mechanisms are possible and desirable? Although one can conjure up visions of a variety of means for fostering and promoting federal-provincial consultation, two approaches seem the most realistic. One could be called the parliamentary approach; it involves the reform of Parliament, particularly the upper house, and ways of enhancing provincial (or regional) representation in that chamber. The second model is the consultative or conference approach whereby federal and provincial governments meet to consult and negotiate on a wide variety of subjects.

The parliamentary approach is not without merit, but achieving reform could take several years. For that reason, I believe we should put immediate emphasis on intergovernmental conferences, in particular, first ministers' conferences.

Before proceeding with an assessment of federal-provincial conferences, past and future, I must recall that Canada is a federation and thus predicated on diversity. Given diversity, some intergovernmental conflict is inevitable. Canada is no exception: federal-provincial differences and disputes are not a new phenomenon in Canada, and they will not disappear in any foreseeable future. Participants in any intergovernmental forum will state differences of opinion and position. Federal-provincial conferences will not be, nor should they be expected to be, free of conflict or tension. What is necessary is to reduce to a minimum those differences that make intergovernmental negotiation and agreement difficult. This objective is most likely to be achieved by institutionalizing conference activity. Conferences are now part of the political landscape, and the public recognizes them as one mechanism whereby governments can exchange views on important subjects of the day. What the public does not accept – a fact reflected in the Macdonald Commission's report – is protracted federal-provincial disputes. The first ministers' conference can be one means (though not the only one) of resolving issues of concern to both orders of government.

CONFERENCES AND THE CANADIAN SYSTEM

The fathers of Confederation selected a federal form of government because there were significant differences amongst the regions that wished to unite. At the time, an important question was how to have the federating units represented in the national institutions. The

solution chosen was a second chamber – the Senate – following the practice developed in the United States in 1789 and used by federations ever since.

Unlike the United States' senate, Canada's second chamber cannot be described as a spectacular success. Since it did not develop as the institution to protect and reflect the views of the provinces, what other mechanism has emerged to do so? To some extent, regional representation in the cabinet accomplishes this objective. So does the federal-provincial conference.

Confederation itself was the result of intergovernmental negotiation. The first intergovernmental conference was a meeting of premiers in 1887 – thus, the serendipity of the title of the present panel, 'The federal-provincial consultation process – 1987 and beyond', reflecting a century of intergovernmental conference activity. (Perhaps Canada Post will consider the centennial of sufficient importance to issue a commemorative stamp.) The first first-ministers' conference was held in 1906. Since then conference activity has become a fact of life in the Canadian federation – and the subject of intense scrutiny, criticized by some scholars and lauded by others. Donald V. Smiley, one of the country's leading authorities on federalism, characterizes the Canadian system as one of 'executive federalism', his term for conference activity.

Had Canada's other institutions fulfilled their original objectives, intergovernmental conferences might not have evolved to their present status. My thesis is that they now must evolve further because the federal and provincial governments are today so interdependent that effective public policies can be made only through intergovernmental consultations, discussions, negotiations, and, in some cases, formal agreements.

THE FIRST MINISTERS' CONFERENCE, PAST AND PRESENT

Before considering the ways in which first ministers' conferences might evolve in Canada, we need to look at their past and present characteristics.

Frequency

The first ministers' conference is the apex of Canadian summitry. As Table 1 illustrates, there have been fifty-eight such conferences from

TABLE 1
Number of first ministers' conferences

1900-9	1	
1910-9	1	
1920-9	1	
1930-9	4	
1940-9	6	
1950-9	6	
Subtotal	19	19
1960-1	12	
1970-1	19	
1980-4	8	
Subtotal	39	39
Total		58

the first in 1906 to the most recent in March 1984. Although they are not a recent phenomenon (Arthur Meighen was the only prime minister who did not preside over one), their frequency has increased dramatically in the past few years. Thirty-nine of the fifty-eight were held in the last quarter-century, since 1960, and Prime Minister Pierre Trudeau presided over twenty-nine – exactly half the total.

Themes

What have been the themes of these first ministers' conferences? A definitive answer is difficult. Although the first ministers may agree on an agenda in advance, once a conference gets underway, virtually any issue can find its way onto the table; no rules or guidelines govern what may or may not be discussed. Nevertheless, one can identify major themes. The classification system used in Table 2 is rather rough, but it gives the general categories of issues discussed.

Clearly, the economy, including fiscal relations, and the Constitution have tended to monopolize the discussions and appear to have been the main reasons for convening conferences. Which of the two themes has been most common is something of a toss-up, depending largely upon how one groups meetings. In the past twenty-five years, constitutional matters have tended to take up most of the time available at first ministers' conferences, and seventeen of them were devoted exclusively to these questions. But many of the

TABLE 2
Main topics of first ministers' conferences

	1906-59	1960-84	1906-84
Economy			
General	3	7	10
Reconstruction	5	0	5
Anti-inflation	-	2	2
Fiscal relations	6	6	12
Constitution	5	17	22
Energy	0	5	5
Postsecondary education	0	1	1
Housing	0	1	1
Total	19	39	58

other twenty-two conferences held in the same period were largely devoted to economic and fiscal matters.

Open and closed conferences

How are first ministers' conferences conducted? Are they public or private or mixed (with some portions open to the press and other portions closed)?

In some instances, such as the constitutional conference of November 1981 and the economic conference of February 1982, participants struck a compromise between informing voters and achieving privacy for discussions by making public their opening and closing statements – speeches that outlined their governments' priorities – and closing the remainder of the conference. This practice is not new – it was used in the 1950s – and neither is the determination of the press.[1]

The first televised federal-provincial conference was that held in February 1968 on the Constitution. I am sure no viewer will ever forget the dramatic exchange between Pierre Elliott Trudeau, then minister of justice, and Daniel Johnson, then premier of Quebec, over who speaks for Quebec. Since then, twelve conferences have been fully televised from beginning to end, competing for ratings with quiz shows and soap operas. Another four have been televised in part.

The televising of first ministers' conferences has had an important

effect on their dynamics.[2] The open conference has taken on many of the characteristics of a spectator sport. The participants number in the hundreds. The leading players are seated around a table, surrounded on all sides by their colleagues, officials, observers, and the media, with each group positioned to look like a cheering section. The spontaneity of debate, found in closed conferences, is simply not present.

With the televising of meetings and the number of participants increasing, the governments have, of necessity, developed alternative consultative devices. One of these is the private conference. In the past ten years, six private conferences have been held at the prime minister's residence, with only the eleven first ministers in attendance.[3] There are no permanent records of these discussions.

In addition, the tradition has emerged of the prime minister's hosting a dinner for his colleagues at some time during each conference. This occasion provides them with an opportunity to discuss issues privately. For example, during the 1975 Energy/Economic Conference and the June 1976 Conference on Established Programs Financing, the eleven first ministers discussed the Constitution over dinner at the prime minister's residence. Unfortunately, these off-the-record discussions usually find their way into the newspapers, thus reducing their effectiveness.[4]

The patterns of conferences

Under what circumstances have first ministers' conferences been convened? No general pattern emerges, but the record indicates that one focal point from about 1945 to 1975 was fiscal arrangements, in particular, the tax-collection agreements between the federal and provincial governments. These agreements lasted for five years, and a conference was held to discuss them at least once every five years. Although these conferences were convened primarily to discuss fiscal matters, once they were underway an exchange of views on the economy was not unusual or unexpected. (Indeed, during the constitutional discussions of 1970, the provinces argued that a conference on the economy was necessary because it had been five years since the last one.)

From the mid-1970s to today, no such pattern has been evident. Conferences have been requested and convened when thought

necessary. Their number has increased so vastly that the first ministers have averaged a meeting every six months; the only year in which they have not held one was 1977.[5] Moreover, the focus of most conferences has shifted from the general to the specific – in particular, to the Constitution, energy, the financing of established programs, and anti-inflation measures. Given the frequency of conferences during the 1970s, it is obvious that governments thought they served a useful purpose. There was never a suggestion that they should not be held.

Indeed, by the beginning of the 1970s, the first ministers' conference had become a recognized, important, and permanent part of the political process in Canada. This assessment is supported by the following chronology of events and agreements:

– The ill-fated Victoria Charter of 1971 included the following provision:

> A Conference of Canada and the First Ministers of the Provinces shall be called by the Prime Minister of Canada at least once a year unless, in any year, a majority of those composing the conference decide that it shall not be held. (Section 48)[6]

– In the communique approved by the annual premiers' conference of 1974, held in Toronto, the premiers

> urged the Prime Minister of Canada to invite the Provincial Premiers to a private discussion prior to the next federal budget. The meeting would consider ways for the provinces and the federal government to take co-operative action on the major economic issues facing Canada today.[7]

The request resulted in the private meeting on the economy of October 1974.

– The 1975 premiers' conference agreed to a resolution that a first ministers' conference on shared-cost programs be convened to discuss hospital insurance and medicare. The result was the June 1976 conference on established programs financing.

– By their 1976 conference, the premiers were calling for an annual first ministers' conference on the economy. This position was

confirmed in the constitutional position the ten provinces adopted a few weeks afterwards. In a letter to the Prime Minister dated 14 October 1976, the premiers reaffirmed their 1971 desire to entrench in the Constitution the regular holding of a first ministers' conference.

– The communique from the 1978 premiers' conference contained a similar sentiment. The premiers called for an annual conference on the economy 'at approximately the end of November each year'.

– By 1978, the idea of a permanent first ministers' conference had also gained the support of the federal government. The communique issued at the end of the Federal-Provincial Conference of First Ministers on the Economy of November 1978 contained the following recommendation:

> First Ministers should meet periodically to review economic objectives and progress being made towards such goals. The next meeting of First Ministers on the economy would be late in 1979.

– The Task Force on Canadian Unity, in its report, *A Future Together*, said:

> To improve their effectiveness we propose that the conference of first ministers be put on a regular annual basis and that additional conferences be held whenever a government secures the agreement of a simple majority of the other ten. Furthermore, to establish agendas, to co-ordinate preparatory research and the development of proposals, and to follow through on the implementation of agreements resulting from such conferences, we suggest that there be a committee on policy issues made up of the eleven ministers responsible for intergovernmental affairs. (Canada 1979, 99)

– Although a first ministers' conference on the economy was scheduled for December 1979, it was cancelled because of the defeat of the Conservative government that month.

– At the 1980 premiers' conference in Manitoba, the premiers

> emphasized that the process of constitutional reform, while extremely important, must not be allowed to interfere with or detract from the concerted effort necessary to respond to current economic problems. . . . They agreed that there must be an immediate renewal of the process of federal/provincial consultation on fiscal and economic matters, including a Conference of Finance Ministers prior to the Federal Budget, and a full-scale First Ministers' Conference on the Economy at the earliest opportunity later this year.

Shortly afterwards, the federal government introduced its constitutional resolution and announced the National Energy Program, plunging the country into both the constitutional crisis and the energy dispute. The consultative approach came to an abrupt end – at least for the time being.

– The communique issued by the premiers' conference of August 1981 commented on the 'level of tension unprecedented in federal-provincial relations'. Rather than wait to react to the now-anticipated request from the premiers for a conference, the Prime Minister suggested, in his letter of June 30 to the premiers, the holding of a conference on the economy preceded by appropriate ministerial consultations. The premiers agreed to this proposal and directed their chairman, William Bennett, to meet with the Prime Minister to plan the conference. The meeting between Mr. Trudeau and Mr. Bennett took place after the Supreme Court of Canada's historic decision on the Constitution. As a result, planning for the economic conference became secondary to and enmeshed with preparation for the constitutional conference of November 1981. The economic conference was finally held in February 1982 and turned into a disaster.

– Meeting in Halifax in August 1982, the premiers called for an immediate conference on the economy, but none was held. (Economic issues were, however, discussed briefly at a dinner during the Conference of First Ministers on Aboriginal Constitutional Matters in 1983.) Two economic conferences had already been held in 1982; their failure was a contributing factor in the federal government's reluctance to convene further meetings. A cooling-off period was needed.

– The 1983 premiers' conference adopted a slightly different tactic. Rather than proposing a first ministers' conference, it suggested bilateral meetings between the federal and provincial governments, after which the Prime Minister could convene a meeting if he thought one was necessary. A number of these bilateral meetings were held, but Mr. Trudeau's international peace initiative prevented their completion.

– Pressure for a first ministers' conference was renewed in 1984. At the 1984 premiers' conference, the twenty-fifth such gathering, held in Charlottetown, the premiers once again called for a first ministers' conference on the economy. Following the September 4 general election, before Brian Mulroney had even been sworn in as Prime Minister, he received a letter from Premier James Lee, as chairman of the premiers' conference , requesting an early meeting. An agenda-setting meeting was scheduled for early November, after the convening of Parliament, to be followed by a major conference on the economy in early 1985.

Given the foregoing, one can make certain general observations. First, the premiers, at their annual meeting in August of each year, usually push for a general conference on the economy. On balance, they have been reasonably successful in accomplishing their objective, although their success rate has not been as high recently as it was in the 1970s. Of the several reasons for this fall-off, the principal one is that other subjects – namely, the Constitution and the native peoples – have competed for the federal government's attention.

Second, over the past ten years, the eleven governments have reached certain understandings about the logistics of a first ministers' conference. It has generally been agreed that the preferable time for it is the fall (so it will precede the striking of provincial budgets) and that portions should be public.

Third, the requested conferences were intended to discuss broad economic issues. (The agenda of the economic conference of February 1978 – see Figure 1 – illustrates the kind of conference the provinces have been seeking.) Leaving aside the unique question of patriation, there has been no groundswell of opinion for first minis-

FIGURE 1
Agenda of the first ministers' conference of February 1978

FEDERAL-PROVINCIAL CONFERENCE OF FIRST MINISTERS
Ottawa
February 13, 14, and 15, 1978
AGENDA

Opening of conference

1 ECONOMIC OUTLOOK AND OBJECTIVES

2 GENERAL ECONOMIC POLICIES
–Growth and cost of the public sector
–Government economic regulation
–Labour relations
–Commercial policy
–Energy
–Other issues

3 REGIONAL ASPECTS OF ECONOMIC DEVELOPMENT

4 SECTORAL POLICIES
–Mining
–Agriculture and transportation
–Housing
–Fisheries
–Forestry
–Tourism
–Industry

5 FOLLOW-UP ARRANGEMENTS

6 CONCLUSION AND SUMMING-UP

7 OTHER BUSINESS

ters' conferences to discuss matters other than those related to the economy, although premiers' conferences have raised other issues.

Outcomes

What kinds of results are first ministers' conferences expected to produce? Are they a forum for specific decisions on specific issues or

for general discussion of broad questions? Have they met their goals in the recent past? Again, no single answer can suffice.

Some first ministers' conferences have been convened with the hope or expectation that a specific result or agreement would emerge. One example is the March 1974 energy agreement, heralded as a great day for co-operative federalism by Prime Minister Trudeau (House of Commons Debates, 28 March 1974: 933). Another is the December 1976 agreement on established programs financing, which in some respects was the culmination of thirty years of negotiations on the tax-collection agreements.

Constitutional conferences have also produced formal agreements. When the federal government and nine of the ten provinces (Quebec being the exception) reached a constitutional accord in November 1981, the conference participants drafted and signed a document to that effect. In 1983, aboriginal groups joined the governments in hammering out an agreement on the first amendment to the Constitution; the resulting document bears the signatures of ten of the first ministers (again, Quebec Premier Lévesque was the exception) plus those of the heads of the two territorial governments and the four aboriginal organizations. In the latter case, the participants' signing of the formal agreement was a clear sign that their governments would proceed with the next step of securing legislative approval under the new amending formula. Such an intergovernmental signing ceremony makes the occasion comparable to the conclusion of an agreement by an international conference.

Not all conferences have been so successful. Many have sought an intergovernmental agreement but failed to reach one despite strenuous efforts on the part of the participants. An example is the Victoria Conference of 1971, at which the eleven first ministers reached an accord that fell apart only days afterwards when Quebec's cabinet rejected it. Another failure was the first ministers' conference of February 1982 described in the opening of this paper. It ended not only with no consensus on broad economic goals but also – in marked contrast to the 1976 negotiations – with no agreement on the future of established programs financing.

That governments are not always able to reach an agreement should not be surprising in a federation. Some conferences have failed, but the issues discussed remain on the agenda for another time; eventually, they are resolved or they fade into the background

as new problems occupy governments' attention. Apart from discussions on fiscal arrangements, which have had a five-year time limit, recent economic conferences have had as their objective not so much a binding agreement as the sharing and exchanging of views in an effort to develop an understanding or consensus on national goals and objectives. These conferences can be said to follow a 'consultative-federalism' model, and constitutional negotiations aside, I believe the trend is towards it.

Purpose

To me, the fundamental difference between the executive-federalism model of conference and the consultative-federalism model is the expectations associated with the outcome of each type. In the former, specific and tangible results are expected; in the latter, they are not. In the former, results can be measured; in the latter, they are more intangible.[8]

Given this fundamental distinction as to purpose, the nonconstitutional conferences of the 1970s are worth more careful examination for possible trends of and approaches to future conference activity. We can identify three broad categories of conferences:

1 Single-issue conferences, followed by bilateral meetings.
2 Meetings in which the participants expect to negotiate and reach a conclusion.
3 General meetings on the economy, more or less following the consultative-federalism model.

Examples of the first kind of conference are those called to discuss energy. In January 1974, the first ministers held a public conference on the subject, followed by a private conference two months later; the latter produced consensus between the federal government and the provinces, producing and consuming. This initial experience proved the exception. Follow-up conferences were held in 1975, 1976, and 1979; their purpose was to exchange views and to obtain an understanding on energy pricing but not to conclude a formal agreement. The individual producing provinces and the federal government would reach accords bilaterally.

The second type of first ministers' conference is exemplified by the two held in 1976 on established programs financing. It was expected that they would result in some kind of intergovernmental agreement – which, while not legally required, was politically desirable. These meetings can be characterized as true negotiating sessions and did result in an agreement being reached. It is worth noting that the finance ministers held a series of meetings before, in between, and after these conferences to work out positions that would assist the first ministers in developing and concluding an agreement. Another factor influencing the dynamics was the considerable degree of interprovincial co-operation (a strategy that caused the federal government some considerable concern).

The fundamentally different third type of conference is exemplified by the two 1978 conferences on the economy. The contrast between these meetings and those of 1976 is very revealing. As the agenda for the February 1978 conference (see Figure 1) suggests, these summits were intended to discuss broad questions of economic policy, not to negotiate agreements. They were to explore ways in which governments might co-ordinate and harmonize their policies. In the course of these discussions, federal policies frequently came in for a rough ride; one consequence was sensitivity and defensiveness on the part of the federal government. 'Fed- bashing' (as opposed to 'province-stomping') was not conducive to the expansion of conference activity and accounts in part for Ottawa's recent reluctance to convene meetings.

Nevertheless, I believe that in the future, first ministers' conferences will continue and will gradually move away from meetings that seek a specific agreement to a specific problem to meetings whose purpose is the discussion of broad issues.[9]

Before closing this section, I need to address two major criticisms of first ministers' conferences: that they usurp the authority of Parliament and that they are held in secret.

The first criticism assumes the growth of the executive-federalism model, which portrays first ministers' conferences as decision-making bodies; the claim is that if they continue to evolve, they will usurp the authority of both Parliament and the provincial legislature.

In my opinion, this assessment does not accurately describe the totality of recent conference activity. The consultative process does not appear to have diminished Parliament's authority. In the cases of

recent economic conferences, Parliament and the provincial legislatures had ample opportunity to debate the matters under discussion. Since the conferences were perceived as on-going, not negotiating, sessions, parliamentarians could ask questions and comment on the issues. Inflation, unemployment, and deficits did not disappear from the parliamentary agenda between meetings. The consensus of both conferences, as reflected in their communiques, was subject to public debate and scrutiny. As a result, parliamentarians had an opportunity for input into the federal-provincial discussions.

In the case of the conferences specifically on established programs financing, the basic federal document was tabled simultaneously there and in Parliament. Before the conclusion of any federal-provincial agreement, all the legislatures had an opportunity to question the policy issues. The debate took approximately nine months from start to finish, and occurred concurrently on two levels – federal-provincial and parliamentary.

As far as the charge of secrecy is concerned, the advent of televised conferences has in some ways made this criticism less valid. The bringing of these meetings to large portions of the public has helped to demystify them and has assisted in legitimizing their place in the political system. At the same time, however, governments do find that the prying eyes of the television cameras reduce their manœuvring room, making it difficult to negotiate and conclude an agreement. Consequently, they may be encouraged to turn to private meetings or arranging to hold portions of a conference without media participation.

The now continuing nature of conference activity, however, means that many of the issues are the subject of debate in between conferences. Moreover, public pressure can lead to the modification of any understandings or agreements – a classic example is the November 1981 constitutional accord and the change that resulted from intensive lobbying by women's and native people's groups.

Summary

From the foregoing comments, one can draw a number of general observations concerning first ministers' conferences.

– The first ministers' conference activity has greatly increased in the past few years.

– Conferences are now likely to be televised in part or in whole.

– As a result of their review of the economy, the premiers, at their annual conference, now usually request an economic conference.

– The belief is growing that an annual conference of first ministers on the economy would be desirable. The consensus is that it should be held at a fixed time, possibly in November before budgets are finalized.

– The trend in conferences appears to be more generalized agendas, geared to exploring alternatives in broad economic policy and establishing national objectives.

– Conferences should no longer be examined as isolated meetings but as an on-going phenomenon, a cumulative experience with one building on the conclusions of the last.

– Conferences should not be expected to produce concrete results; that is, negotiated deals.

– A certain amount of intergovernmental criticism on matters of public policy is not unusual. The degree of tension may not be a result of the conference itself since other issues may have a deleterious effect on discussions.

Moreover, it is clear that the personalities of the participants are an important factor in the success of any conference. Conferences will succeed if a majority of the participants desire that end.

THE FUTURE

What of the future? In my opinion, in recent years we have witnessed the emergence, not the decline, of first ministers' conference activity – a new kind of co-operative federalism.

We have probably completed the first phase: recognition and establishment of the legitimacy of first ministers' conferences. The bitterness of the constitutional debate is now behind us. The economic realities of the day require more, not less, intergovernmental consultation. These factors, combined with a desire to see greater provincial (or regional) representation at the

centre, should result in these conferences' being maintained and possibly increased in frequency. The next logical phase in this evolution of our federal system is institutionalization of an annual meeting, leading ultimately to constitutional entrenchment of first ministers' conferences.[10]

The first step in the process will be securing agreement that first ministers' conferences be held at a predetermined time on a fixed basis. Once acceptance of this annual meeting is achieved, permanent traditions may emerge to supplement those in existence today. Present traditions include an established speaking order (the order of entry into Confederation), the chairmanship of the prime minister of Canada, and the making of an opening statement by each participant. The vast majority of meetings have been held in Ottawa (those that have been held elsewhere have been scheduled in conjunction with some celebration – such as British Columbia's centennial in Victoria in 1971), and it seems likely that many will continue to be held there. Conferences will also probably continue to be televised in whole or in part.

An increase seems likely in the trend of one conference's building on another, with each agenda reflecting to some extent what has gone on before. Expectations of follow-up will also grow. In addition, having a fixed date should influence the timing of other governmental activities, such as the presentation of budgets, legislative timetables, and possibly even elections.

New mechanisms and traditions

What new traditions for first ministers' conventions might emerge over time? A number come to mind:

– Participation of other groups. The two recent meetings on the Constitution had the active participation of native people's organizations. In 1982 Gerald Bouey, governor of the Bank of Canada, attended a first ministers' conference to discuss and defend the Bank's interest-rate policies. Admittedly, these were special cases, but they have established a precedent. It is not inconceivable that groups representing labour, business, health care, or other interests may participate in future conferences.

– A permanent secretariat. The Canadian Intergovernmental Conference Secretariat (CICS), an organization jointly funded by federal and provincial governments, currently provides secretarial, translation, and logistical services to first ministers' conferences. This organization or a successor could have its mandate expanded to include the production of a variety of research or policy studies by staff seconded from all governments.

– The continuation of specific-issue conferences. The existence of an annual conference on the economy should not prevent the holding of other first ministers' conferences on constitutional matters or other specific issues, such as energy or fiscal arrangements. These conferences should be held separately from the general conferences on the economy.

– Clarification of the purpose of the annual conference. To be successful, an annual economic meeting should not be a deadlock-breaking mechanism, nor should other agenda items detract from the economic questions of the day. Clearly, the distinction between the two types of meetings is fine, but given their different purposes, governments will probably attempt to maintain it. They will be reluctant to see a repetition of the February 1982 meeting, at which the attention was divided between a general discussion on the economy and an eleventh-hour attempt to reach an agreement on established programs financing.

– Increased preparation for conferences. Before a first ministers' conference, other ministers will probably hold meetings to plan, review, and report on specific sectors. This is particularly likely to happen with the finance ministers, but it is not unreasonsable to expect preconference consultation and preparation from the ministers responsible for other subjects on the current federal-provincial agenda. Moreover, these ministerial consultations could very well include meetings with representatives of nongovernmental organizations, such as the discussions with the private sector that took place in 1978.

– Conference follow-up. It is realistic to expect the first ministers to assign to ministers the task of following up specific problems and reporting back to the next meeting. Alternatively, they may request studies from organizations such as the Economic Council of Canada

(ECC). The latter approach was used, for example, at the February 1978 Conference; the first ministers asked the ECC to assume the responsibility for analysing price and cost developments for a limited post-control period. (Alberta, 1978)

– Continuation of other forums. Institutionalized first ministers' conferences will not pre-empt other forums for consultation, such as bilateral or regional meetings of premiers or the annual premiers' conference. Neither will it preclude the federal government's establishing parliamentary committees or task forces on particular policy questions with the results being fed into the federal-provincial process, as was done recently in the areas of fiscal arrangements and Senate reform.

– Establishment of decision-making guidelines. The evolution of decision-making rules is very difficult to predict because the first ministers now have no norms or guidelines, and practice has varied from conference to conference. During the constitutional conferences of the 1970s and earlier, the rule of unanimity prevailed by convention. In October 1980, the federal government's unilateral action on patriation shattered that illusion. Provincial protest at the time showed that a consensus amongst governments is essential to developing an agreement.

As for decisions at economic conferences, Alberta Premier Peter Lougheed addressed this issue at the June 1976 conference. He said:

> We submit that most major Canadian economic and fiscal policies should be by consensus among the majority of the provinces and the federal government. The combined impact of the fiscal policies of a majority of provinces is too substantial to be ignored any longer. No coherent fiscal and economic policy for Canada can be developed if decisions of the 11 governments continue to be unco-ordinated. It is improbable that a unanimous agreement would occur, but consensus between the majority provincial view and the federal government would have positive benefits.
>
> This 'partnership approach' to fiscal decision-making in Canada could commence with perhaps an annual meeting of First Ministers to discuss and decide on the main thrust of economic policy through the coming year. It would then be

up to each individual province and the federal government to decide the specific mix of taxing and spending policies to fit within the general consensus. (Alberta 1977, 81)

The consensus mechanism of the new amending formula for the Constitution – the consent of Parliament plus two-thirds of the provinces representing 50 per cent of the population – may eventually become the basis for decisions at economic conferences. It is at least one basis for the emergence of a convention for determining the minimum measure of agreement at nonconstitutional conferences.

CONCLUSION

I cannot overemphasize the importance of the partnership between the federal and provincial governments. In the economic sphere, today's governments are interdependent, and although one may yearn for water-tight compartments, they are difficult to achieve. Certainty, stability, and predictability in the federal-provincial consultative process will go a long way towards reducing friction within the system (although it can never be eliminated). The mechanism of first ministers' conferences already exists and can be used without any formal amendment to the Constitution. Institutionalization would simply be a recognition of the way in which governments in Canada have resolved the vast majority of their differences to date. Consultation-through-a-conference may not be a perfect instrument – the process may be flawed and individual conferences may be unsuccessful – but it has been one of our federal system's principal vehicles of adaptation since 1906.

NOTES

1 The issue of whether conferences should be open or closed was vividly illustrated in December 1976, when the press refused to leave the room after their 'photo opportunity'. Charles Lynch, speaking on their behalf, was steadfast in saying they would not leave. They were expectantly waiting to see the verbal exchanges between the Prime Minister and the newly elected premier of Quebec, René Lévesque. Unfortunately for them, they did not get their wish. Suspecting that something like this might occur, the Prime Minister had had another room set up, to which he adjourned the meeting.

2 Ministerial meetings are not televised – only first ministers' conferences, the summits.

3 These six meetings included the March 1974 meeting, during which the first energy agreement was reached; the October 1975 meeting on the Anti-Inflation Program; and the June 1980 meeting, after the Quebec referendum, to map out the schedule for the promised constitutional discussions.

4 The rules of secrecy well established for the cabinet do not apply to first ministers' discussions.

5 Even then, the Prime Minister travelled across the country in the fall, meeting privately with the premiers to plan and prepare for the 1978 conference on the economy.

6 A copy of the Victoria Charter is contained in Canadian Intergovernmental Conference Secretariat (1975, 440-85).

7 First ministers' conferences and annual premiers' conferences issue their communiques in the form of press releases, which are not widely distributed. To make conference communiques more accessible to the public and to scholars, Alberta's Department of Federal and Intergovernmental Affairs has made a practice of reprinting them in its annual reports. I took each of the conference quotations in this list from the report of the year following the date of the conference.

8 In the course of explorations of broad policy options, the first ministers may decide that a specific agreement of some kind is desirable, but it comes as a result of a general exchange of views and not as the predetermined objective of the meeting. Or an agreement may emerge over time – not as the result of a single meeting but from a cumulative process of discussion.

9 The exception to this general observation is a situation in which a government seeks an agreement in the form of a constitutional amendment. Under the amending formula of the Constitution Act, 1982, any constitutional agreement forthcoming from a first ministers' conference must be approved by Parliament and by two-thirds of the provinces representing 50 per cent of the population before it can become law.

10 It should be noted that limited entrenchment has already taken place with the provisions in the Constitution Act, 1982 and in its amendment that call for a series of meetings on aboriginal rights.

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A federal view of consultation

Claude Lemelin

My purpose here is to provide some details on the continuing consultative process that was launched in 1980 for the revision of the fiscal arrangements and to speculate on the general direction that process may take during the next few years.

I must first note that we do not have an integrated process for the management of the money and power arrangements within the federation or for consultations among governments about those arrangements. It is true that four of the basic components – equalization, transfers for health care and postsecondary education, and tax harmonization – are loosely linked for consultations by virtue of the fact that their statutory basis is the Federal-Provincial Fiscal Arrangements and Established Programs Financing (EPF) Act. It mandates a quinquennial revision of the equalization formula and other arrangements, which provides a useful focus for reviewing those four elements. But our fiscal and policy arrangements also have three other important components – the Canada Assistance Plan, regional-development, arrangements among governments, and energy arrangements. All of them have lives of their own. Although they play important roles in the federal-provincial sharing of money and power, I will not have much to say about them until the end of my remarks here.

CONSULTATION IN SIX STAGES: 1981 TO 1984

As for the first group of programs, the consultative process for the

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last set of revisions began in June 1980, almost twenty-two months before the end of the fiscal year 1981/2. They are not yet ended. In fact we seem to have moved from a notional five-year adjustment of these arrangements to a more or less continuous set of revisions.

So far, this revision process has been through six stages. The first two preceded the 1981 budget and were a modest innovation in the consultative process; the others could be anticipated in that budget.

Stage 1

The first stage in the revision process was a set of exploratory discussions among officials before the formulation of the federal proposals. Meetings were held in June 1980 and in February and June 1981 for the purpose of reviewing the existing arrangements, canvassing the views of provincial and federal officials on possible changes, and making the provinces aware of some of the federal government's working hypotheses. These meetings were also used to explore alternative approaches, some of them from nongovernmental sources (for example, proposals for a two-tier equalization formula), for identifying ideas that were 'nonstarters', and also for bringing together common data bases, particularly in the case of established programs financing, about which there were very significant disagreements, not so much on the data but on the way it should be manipulated.

The participants, who were all officials at that stage, did not have any formal mandate, but some of them, including the federal officials, were authorized to provide broad hints as to the thinking of their governments and the views of their ministers.

Stage 2

The second stage, in which Rod Dobell was involved, overlapped with the first. It was, of course, a public consultation by a parliamentary task force. Established on 5 February 1981, ten months before the publication of the federal proposals, the group began its work in April and held meetings in all the provincial and territorial capitals.

The submission made by the federal minister of finance on 23 April was significant quite aside from whatever contribution it made to the work of the task force. It was a second set of signals, this time very public, on the direction of the federal government's thinking. In his

presentation, the minister discussed, among other things, tax harmonization, the issue of interprovincial fiscal balance, federal-provincial political balance arising from fiscal arrangements, federal concerns about accountability and visibility, the treatment of resource revenues, and the status of Ontario under the equalization formula. All these issues were the objects of formal federal proposals a few months later.

The task force reported in August 1981. Two months later came a ministerial meeting, but as everybody attending knew that Allan MacEachen was then still at the critical stage of formulating the new fiscal arrangements, it was agreed that there was no point in discussing them. The provincial ministers did note, however, that they were very impatient, after more than a year of informal discussions, to find out exactly what the federal government intended.

Stage 3

The publication of the federal proposals as a budget document in November 1981 launched the third stage of the revision, formal consultations at the ministerial and official levels. Ministerial conferences were held in Halifax on 23 and 24 November, in Toronto on 14 and 15 December, and Ottawa on 22 January and also on 3 February. The last one was the day before the infamous first ministers' conference, which Peter Meekison has rightly proclaimed a classic failure.

Each of these ministerial meetings was preceded by a preparatory meeting of the continuing committee of officials, essentially the committee of deputy ministers of finance.

Following the not very fruitful discussion of fiscal arrangements at the first ministers' conference on the economy on 3 and 4 February, there were a series of bilateral consultations, mostly by telex. These negotiations continued up to the introduction of the bill amending the EPF Act on 19 March and its enactment on 7 April 1982. (Its application was retroactive to 1 April, which was the start of the first fiscal year of the new five-year period of the arrangement.)

I might note that the changes from the original federal proposals that resulted from the consultative process mostly had to do with equalization – the shift to the five-province standard and the expansion of the revenues covered. As far as I can recall, the

minimum-payment provisions and the transitional-payment provisions were also proposed during this negotiation period.

I might also note that some of the minister of finance's proposals – those relating to tax and fiscal harmonization – were not really pursued either by officials or ministers. Rather, the process focused very rapidly on the fiscal aspects of the health-care and postsecondary-education arrangements, as well as on the equalization formula.

In my view, it was quite clear in the original proposals that the process would not end with passage of the amendment. Indeed, the proposals relating to health-care and postsecondary-education arrangements already foresaw a pursuit of negotiations following the passage of the amendments to the EPF Act. In other words, the program conditions for health-care funding were to be discussed at a later stage. Indeed, this stipulation became an important point of contention in the consultative process: the provincial ministers wanted both the program conditions and the fiscal aspects of the arrangements discussed simultaneously by both the ministers of finance and the health ministers. But the federal government believed that this was not an appropriate way to proceed.

Stages 4, 5, and 6

That brings me to the fourth, fifth, and sixth stages, which proceeded more or less simultaneously after passage of the act. The fourth stage consisted of consultations among officials on consequent changes to the regulations governing the equalization program. Here I think there was a modest innovation, righting previous wrongs in the sense that these consultations were more formal and more extensive than had been the case in the past. A special subcommittee was set up. Meetings of officials were held in November and December 1982, and in January 1983 it considered extensive documentation prepared by both federal and provincial officials. This subcommittee reported in March 1982, following some further consultations, mostly bilateral. The regulations for equalization were enacted in October 1983.

The fifth stage was the revision of the program conditions for health-care transfers. Since this conference has discussed these changes extensively, I won't dwell on them.

The sixth stage, which was also forecast in the original November 1981 proposals, was the imposition of 6-per-cent and 5-per-cent limits

on rises in the postsecondary-education transfer for two fiscal years, in line with the anti-inflation program.

That brings us up to the present, and I wouldn't be prepared to say that the revision process has ended.

THE FUTURE

That history brings me to the prospects for 1987 and beyond – or perhaps more accurately to the prospects for the rest of 1984, for 1985, and for 1986. I think we may have no lull between settling the sequels of what was started in 1981 and going into the next quinquennial comprehensive review. Indeed, we may have moved into quite a different approach to the review process – one in which we make adjustments piecemeal at irregular intervals. From the federal viewpoint, such a situation has the advantage of adding fiscal flexibility to decision-making. From provincial viewpoints, it has the obvious disadvantage of introducing an element of uncertainty into the province's own fiscal planning.

In any case, if past practices are a guide, we can expect the more formal discussions leading to the next revision of the EPF Act to start in the fall of 1985 or in early 1986.

Certain decisions will have to be made for that revision. The first is the basic strategy decision of defining its scope. How much should be tackled simultaneously? The approach in the past has varied. In 1981-2, for example, there was a fairly narrow focus on equalization and what is in the EPF Act. In 1975-6, a conscious decision was made to broaden the discussions. The goal was to integrate consideration of the options not only for the various elements of the EPF Act but also for the Canada Assistance Plan, economic-development arrangements, education and training transfers, tax and fiscal harmonization, and even some purely federal programs that have national fiscal implications, such as Unemployment Insurance. For the next round, people may argue that the time has come to overhaul the basic structure of the arrangements, that even if it proves impossible to complete the revision of all components, it would be useful to try to develop a broad consensus on the system's architecture. However, it may also be argued that such a review would be biting perhaps more than we could chew, that it would be wiser to muddle through with the piecemeal approach.

Among the other considerations that one can anticipate are (1) the probable coincidence, at least during some stage of the renegotiations, of energy agreements with Alberta, Saskatchewan, and British Columbia, and (2) the publication of the Macdonald Commission's report before discussions enter the critical phase. Of course, it is very difficult now to anticipate what the commission's recommendations on fiscal federalism might be. Three of the challenges it posted a month ago – those concerning education and training, social support, and intergovernmental relations and the economic union – could certainly have major fiscal implications, but it is not yet clear whether the commission will make specific recommendations on the fiscal aspects of these issues.

The general economic environment will also have an effect. It seems probable that both the federal and the provincial governments will approach the revision in tight fiscal situations. If so, it is very likely that the federal government will regard the yield of the current arrangements as the maximum it can contemplate for the future. This probable spirit of restraint would have implications for the strategic choice of defining the boundaries of revision: reviewing two or three fiscal elements at the same time would at least provide the negotiators with a degree of flexibility, since they could make compensatory changes in various programs.

As to approach, I would expect to see some parliamentary involvement before the governments enter the critical stage of the consultative process.

Discussion

RAY PROTTI (federal Department of Labour): I would like to comment on Rod Dobell's suggestion of bringing the conflict-resolution machinery of labour relations into the federal-provincial arena. Looking back over the last twenty-five years of federal-provincial relations, I see that we have been blessed with a highly adaptable system. I am impressed by the huge amounts of money that are transferred from the taxpayers' dollars through the provincial governments to an enormous variety of institutions and individuals in a very flexible way. Now if the federal government were willing to bind itself to labour relation's mechanisms of conflict resolution, my guess is that it might demand in return an agreement spelling out in detail the terms and conditions of those transfer programs. Recall that some of the collective agreements we have in place are two or three hundred pages long. It seems to me that such a detailed agreement would have the potential of introducing an enormous amount of rigidity into the system.

If there is a lesson to be learned from labour relations that is applicable to federal-provincial relations, it is that mutually satisfactory outcomes are found *because* the parties to the negotiations have left themselves room to manoeuvre. Room for manoeuvring means flexibility and adaptability. Where we have institutional arrangements that promote flexibility and adaptability, we should protect them, and where we have rigidities in place, we should find ways to avoid them.

RODNEY DOBELL: Granting all that Mr. Protti says about the need for flexibility and adaptability, it is also true that federal flexibility is provincial uncertainty. In some cases, it would be nice to have a clearer, more stable arrangement.

I think the main point – that the machinery of labour relations may have less immediate application than is implied in my paper – is probably correct. What I want to emphasize is the basic notion of labour relations: that people around a table can have different views and still recognize that they ultimately have to emerge with a workable agreement. What has to prevail is, as has been said here today, 'tolerance and civility in the face of adversity'. Even though it is the federal government that ultimately passes the legislation, the

setting is, in some senses, a negotiating setting. In it, as Richard Bird said, 'Consensus and compromise are not a luxury but a necessity'.

CLAUDE LEMELIN: I have a lot of faith in the political dynamics of our federation. Besides, I doubt that the federal government or the provincial governments would ever agree to delegate decision-making powers to a body of arbitrators, if only because doing so would singularly complicate the relationship between the executive and the legislature. The government is responsible to a parliamentary body; it has to retain the capacity to make decisions that ministers think can be defended in that legislature.

THE HONOURABLE BRIAN R.D. SMITH (Attorney General, British Columbia): I find that attempting to settle dominion-provincial problems, which are often very complex, by means of tribunals, the courts, or arbitrators brings about unsatisfactory and sometimes rigid solutions. This is not at all the way to resolve problems. All it does is to set up a desire for an appeal and another round and our dukes are up even higher than they were when we started. If we took about half the energy we use in fighting each other and devoted it to working co-operatively, though joint task forces, committees, and panels, we would have more solutions.

I took this to be the thrust of the panel. Do you see, Mr. Lemelin, any reason why we didn't do more co-operative problem-solving? It used to happen. I don't know why we have become so combative.

CLAUDE LEMELIN: I am not inclined to develop catastrophic scenarios for the future. As Peter Meekison pointed out, in 1980 and 1981, we were in quite exceptional circumstances including very difficult energy negotiations, very difficult constitutional negotiations, and a state of imbalance in the workings of the federation by virtue of the fact that the Quebec government, in the aftermath of the referendum, could not participate in the usual way in the negotiating process. That the conjunction of all these circumstances affected the way negotiations developed leads me to believe that we will plod along in 1984, 1985, and 1986 without a nexus of conflict comparable to the one we encountered in 1981.

I also think that the fiscal discussions of 1981 and 1982 did not involve much regional conflict. The conflict was essentially federal-

provincial, arising from the fact that for the first time in the postwar period, the federal government was approaching the revision of the fiscal arrangements with a view to stabilizing the pay-out, rather than making it more generous. The provincial governments' constitutional mandate was to resist this approach as much as possible, and I don't blame them for having tried their best to blunt the federal intentions.

DON ROWLATT: I was fortunate enough to be at both the 1976-7 and the 1981-2 negotiations. There was a very interesting difference between the two that I don't entirely understand. In 1976-7 there was a great deal of federal-provincial conflict. There was also a great deal of provincial determination to hold fast. I remember the ten finance ministers standing at the end of the hall, united in opposition to the federal proposal, choosing to have one speak for all. And when a television reporter asked M. Parizeau a question in French, he replied, 'I'm sorry, this man is our spokesman.' The provincial solidarity was real, and so were the conflicts over money, over regional differences, over the legitimacy of the new block-funding approach. Yet somehow the participants were committed to finding a consensus that could lead to a decision, and that's what happened.

In 1981-2, there was never this commitment, among federal or provincial participants, to finding consensus. The process in 1981-2 was purely consultation, it was not negotiation, while the process in 1976 was both consultation and negotiation. I would like to know what our political scientists see as the cause of this fundamental difference.

RODNEY DOBELL: In posing the question, you've put your finger on the answer. In 1976-7, there was a commitment to establishing agreement. Of course, both sides had leverage: the federal government because it always does, having the power to pass the legislation; the provinces because the federal government badly wanted agreement on predetermined health-care arrangements. But each side was willing to come out with and to accept concessions.

In 1981-2, however, there simply wasn't that commitment to reach agreement. Rather, there was a willingness to accept the breakdown of negotiations. You can speculate on the reasons for this attitude. It was partly , I suppose, because federal-provincial relations had

broken down elsewhere. Then, too, there was a sense that the Liberals should not have come to power in 1980 and, therefore, that the provinces were not dealing with the right government.

PETER MEEKISON: The times and circumstances were totally different for the two sets of negotiations. Those of 1976-7 were, as Dr. Rowlatt says, real negotiations on a whole new approach to funding. When the original paper was tabled at the first ministers' conference in June 1976, no final road was laid out. There was opportunity for a great deal of discussion, public and private. The procedure in 1980-2 was fundamentally different. For one thing, the existence of the Breau Task Force put direct federal-provincial negotiations on the side. And the provinces first saw the federal proposals on health care and postsecondary education at the first ministers' conference at the beginning of February 1982, only two months before the old agreement expired. There wasn't time even to begin discussions before it ran out. As Claude Lemelin said, the discussions are still going on today. Thus, the dynamic changed completely, and with it, in the long run, the character of the fiscal arrangements.

PART IX
OVERVIEWS

National standards in public services

Peter Leslie

My assignment as a rapporteur is to gather together the various strands of argument and discussion and to weave them into whole cloth. To produce a discernible pattern, I shall necessarily be selective, picking up some threads while leaving others aside, and I shall also add a few threads of my own.

BROADENING THE AGENDA

The pattern I saw in the discussion as the conference proceeded was more complex than one might have anticipated at the outset. It was complex because the problems to be addressed in revising or redesigning the fiscal arrangements for 1987 are greater than those apparently recognized in the last few quinquennial revisions. The current problems involve issues larger than those most of us, it would seem, came in a frame of mind to debate.

Tom Courchene's opening remarks signalled the importance of broadening the agenda. He suggested that through much of the postwar period, especially the 1960s, a rapidly expanding economy permitted us to focus on techniques for extending public services. The mood of the times favoured sacrificing a little efficiency in order to achieve greater social equity. He might have added, as A.W. Johnson did later that day, that during the 1960s a major problem for the federal government was designing programs that the provinces could be induced to co-operate in implementing. He could also have underlined the difficulties involved in achieving equity among persons and among regions at the same time – that is, the conundrum

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of how to extend social programs without bankrupting those provinces that have relatively small revenue bases. The essence of Professor Courchene's message, however, was all the starker for being stripped of these embellishments. He argued that the redesign of the fiscal arrangements must break with earlier patterns of inventing new techniques for transferring more cash or offering more services to persons and businesses.

It appeared to me that all conference participants took to heart Professor Courchene's message. They were agreed that the renegotiation of the fiscal arrangements must be conditioned by our recent experience of 'slowth'. Domestically, Canada is experiencing flat productivity growth and high unemployment; internationally, it faces an ever more competitive and even hostile economic environment. This situation translates into mounting fiscal pressure on governments, which forces us to look for ways of rationalizing our social programs: income support, health care, and education. Speakers seemed quite sympathetic to the view that if we fail to exercise budgetary constraint, we also fail to 'rekindle the failing engines of economic growth'. They seemed prepared to reconsider, as they were enjoined to do, the trade-off between equity and efficiency and how to tip the balance towards efficiency.

Professor Courchene suggested that decentralizing the federal system would improve and, in fact, might be a device for shrinking the public sector, as it encouraged the provinces to experiment with the private delivery of publicly funded services. Here too, the participants seemed broadly sympathetic.

The two faces of decentralization

One of the interesting features of the conference, however, was that it opened up the question of centralization versus decentralization in a much broader sense than the one in which it was originally presented. To explain my point, I must distinguish between two broad meanings of 'decentralization'.

On the one hand is decentralization of a kind or degree that encourages innovation and experimentation in the delivery of public services that provide income support, health care, and education. Decentralization in this sense facilitates adaptation to local or regional conditions and permits flexibility in program design as conditions change or as innovators find new ways of meeting policy

goals. It promotes efficiency in the implementation of programs that are basically the same or that at least aim for the same objectives. Underlying these programs is a common notion of citizenship that implies all individuals in the country have broadly comparable entitlements to public services and broadly comparable obligations to contribute to the realization of public purposes. Most of the conference participants apparently thought of decentralization in these terms, and they endorsed it only in this particular sense.

Decentralization may also be understood in a much more fundamental sense. It may be treated as a device to accommodate ideological and cultural diversity, permitting wide variations in program standards and allowing for – perhaps even encouraging – differences in the objectives of major governmental programs. Implicit in this meaning of decentralization is the expectation that publicly provided services and their financing will reflect a distinctive relationship between the individual citizen and the collectivity, a relationship varying in the Canadian case by province and region.

On the whole, the conference participants were much more inclined to discuss decentralization in the first sense than in the second. They paid relatively little attention to decentralization as a means of accommodating citizen preferences that vary by province or region. That there might be within Canada several distinct and perhaps competing conceptions of community, suggesting regional variations in the relationship between the individual and the larger society, was scarcely acknowledged other than by Claude Ryan, Roy Romanow, and Robert Stanfield. Most of us tended to assume commonality of public purpose or at least that discussion and accommodation could produce consensus on policy goals.

Thus, in my observation, the mood of the conference favoured working towards loosely national programs while avoiding absolute uniformity of program design and standardized modes of implementation.

The role of the federal government

The participants differed, however, in their preferences regarding the appropriate roles for the federal government and the provinces. These differences were crystallized in the remarks of Professor Johnson and Mr. Ryan.

Professor Johnson emphasized that any nation requires certain transcending values. For Canadians, he said, one of those values – a part of our political ethos – is the sharing, to some degree, of our wealth and income with one another; we must, as Canadians, be able to enjoy comparable services as we voyage across the land. For Professor Johnson, it is an axiom that the chief instrument for achieving this objective is and must remain the national government, answering to its own, national constituency. No government, he said, can abdicate its responsibility to another or to a nonelected, nonresponsible federal-provincial body. He seemed to imply, although he did not explicitly say, that the federal government may properly use its fiscal powers to induce the provinces to implement programs that have national, *federally defined*, standards.

By contrast, Mr. Ryan affirmed that any national standards in the fields of social policy, health care, and postsecondary education 'should be governed by an agreement among the governments concerned' and that all shared-cost programs must allow for provincial opting-out with full financial compensation. What he said about postsecondary education evidently represents his view on all subjects within primarily provincial jurisdiction: 'the federal government should provide leadership of inspiration, encouragement, and support rather than leadership based on control and supervision'.

Conference participants were evidently sympathetic to leadership providing inspiration, encouragement, and support. On the other hand, they showed little disposition to ask themselves how effective it could be if the federal government totally abjured control and supervision. How much fiscal leverage is to be permitted? It is hard to imagine what provincial government would enter a shared-cost agreement if it could obtain just as large a cash payment by staying out. I have yet to hear of a provincial treasurer who preferred a dollar with strings on it to a dollar with none.

More generally, I was a little surprised that the conference did not more fully thrash out the matter of how far the federal government should go in attempting to define and implement national standards. I am giving it central place in my own remarks. In doing so, I find it useful to focus separately on the three main policy areas singled out for attention – health care, postsecondary education, and income security – and on the equalization program, which is, as Mr. Ryan

emphasized, the 'cornerstone of any policy for redistributing financial resources among the federal government and the provinces'.

HEALTH CARE

There is evidently widespread public support in Canada for state involvement in the provision of health-care services and also for the principle that the quality of care should not be markedly inferior in some provinces relative to others. Nonetheless, William G. Watson could find no 'overriding theoretical presumption in favour of Canada's present [system of] financing of health care'. He attributed federally subsidized medicare to a combination of 'ideological considerations, whose influence economists usually discount' and 'the self-interested behaviour of . . . politicians and bureaucrats'. Of course, he is quite right about the ideological considerations and about self-interested behaviour, too.

Many Canadians, probably an overwhelming majority, simply find it odious that their fellow citizens' access to health care might be conditioned by their private incomes. Private insurance schemes are an inadequate solution because, as many of us remember from the days before the introduction of medicare, private insurers differentiate good risks from bad. The old and the infirm, if they can get insurance at all, have to pay much higher premiums than the young and apparently healthy. This was why the federal Medical Care Act, borrowing the language of an existing Saskatchewan statute, stipulates that to qualify for a federal subsidy, a provincial scheme must 'provide for the furnishing of insured services upon uniform terms and conditions' – that is, regardless of risk. A program of this kind is an expression of community values or ideology. Furthermore, presumably because Canadians' sense of community is not wholly contained within provincial boundaries, the view prevailed that the province of residence should not be a relevant criterion, any more than private insurability or private wealth, for access to medical care.

Given such preferences, it is hardly surprising that federal politicians responded with a public hospital-insurance scheme in 1958 and with a public medical-care scheme ten years later. The same facts explain why provincial politicians, including reluctant ones, such as Ontario's Premier John Robarts, accepted the federal money in spite

of the long-term financial commitment it implied. The *political* facts were that people wanted something that only government could provide, and the politicians accommodated them.

A move towards national standards?

These facts are just as relevant today as they were fifteen or twenty-five years ago, perhaps more so. The principles of access and universality have been extended. These principles may now (it is too early to tell) encompass concern with national standards, something the federal government did not attempt to define, let alone to impose, when it first devised the two conditional-grant schemes for health care. In those early years, the federal government told the provinces, in effect: provide such services as you wish or as are within your financial capability; you will be eligible for the federal subsidy if those services are available to all your residents upon equal terms and conditions. This principle was retained in the 1977 scheme for established programs financing (EPF), together with the new requirement that coverage (the range of services insured) must be comprehensive. In other words, it obliged the provinces to go on doing what they had done since 1971 or before: namely, to insure all medically necessary services provided by medical practitioners (except those services provided to exempted persons, such as members of the armed forces).

What was missing from the 1977 act was a credible enforcement mechanism, and that is what the 1984 Canada Health Act contains. The financial penalties it threatens create the potential for the federal imposition of national standards upon the provincial governments. The political impulsion is obvious. So is the potential financial burden upon the provincial treasuries. So is the infringement of Canadian constitutional principles.

It is important, however, not to exaggerate either the financial or the constitutional implications of the act nor to attribute motives to its framers that they may not have had. The intent may have been merely to insist that such services as are available must be covered by provincial insurance and thus be available to all residents of the province. This was my own first impression of what the act stipulates, and it is an impression that has been confirmed by discussions I have had with a number of federal officials.

On the other hand, some of the implications of the act are unclear because of its reference to 'medically necessary services'. What happens if a patient (or his or her surviving kin), supported by the individual's doctor, insists that he or she was unable to obtain a certain 'medically necessary' form of treatment – say, a heart transplant, to take an appropriately expensive case – because the provincial minister of health had determined it would not be provided under the province's health scheme? The act's enforcement procedures, which were summarized in Rod Dobell's presentation, allow the federal cabinet to exercise wide discretion in the imposition of financial penalties on any province considered not to be living up to the enshrined principles of universality, accessibility, comprehensiveness, portability, and public administration. Moreover, I am inclined to think that the Supreme Court would invalidate any financial action that did try to impose program standards on a province. Yet the act does have some suggestion (or one is read into it by its critics) that it provides the legislative basis for federal enforcement of program standards. This would be Mr. Ryan's 'leadership based on control and supervision' with a vengeance.

The conference did not address these matters. Though they involve much detail and no small amount of speculation, I rather regretted the absence of debate on the issues surrounding the definition and enforcement of national standards – their constitutionality, their political feasibility, their financial implications, and their legitimacy. These questions have come most explicitly onto the political agenda in relation to health care, and circumstances suggest that they will not subside with the passage of the Canada Health Act. On the contrary, they are likely to receive increasing attention in the future, in respect of both health care and other areas currently or formerly covered by conditional grants.

POSTSECONDARY EDUCATION

David Cameron's message was that the federal government is likely, for reasons that will easily survive the end of the Trudeau era, to treat higher education as a matter of some priority. There is, he said, dissatisfaction with the meagre effects of heavy federal spending under EPF. One solution would be to save money by leaving the area entirely to the provinces, but, he noted, the earlier consensus among provincial governments about their obligations in postsecondary

education is wearing thin. As evidence, he mentioned Quebec's imposition of a fee differential for out-of-province students and cutbacks in British Columbia. Since this erosion is occurring at the very time that public opinion seems to be favouring higher education, Ottawa is disposed to maintain and extend its participation, but, as Mr. Cameron put it, to 'spend smarter'. A particular concern of the federal government's is likely to be facilitating the adaptation of a mature higher-education system to changing conditions and requirements.

David Slater noted that postsecondary education is a 'bundle', which he apparently meant in more than the financial sense. It comprises skills development, retraining, personal development, research, and so forth. For some elements in the bundle (such as undergraduate training, with its emphasis on personal development), the private-good aspect is quite prominent relative to the public-good aspect, and the public-good aspect tends to be provincial rather than national. Other elements in the bundle (such as research), however, confer a relatively large public benefit that is likely to be felt nationally, rather than merely provincially. Elements in the bundle conferring large public benefits that accrue to the nation as a whole, he said, are inadequately subsidized at present, and the federal role relating to them should be expanded. Dr. Slater seemed to imply that decisions will be made (or ought to be made) about the specific objectives the federal government should seek to support. The 'spend smarter' theme was again evident.

Claude Forget was equally emphatic about the need for deliberate selection of policy objectives in education, and he made some imaginative and thoughtful observations about the choices before us. Education is a national problem because 'investment in human capital represents a very large share of national investment'. Consequently, education services bear heavily upon the health and growth of the economy – evidently a national concern. However,

> Education is also a national concern in a more precise sense: the choices to be made among the various options should probably not be made in one way in province A and in some other way in province B. The resulting disparities might be more than we could live with. The need is, therefore, not only for innovation but also for careful harmonization of provincial education policies.

M. Forget concluded that Ottawa's cash contribution under EPF might be 'used as a lever and a lubricant to encourage harmonization of provincial policies'. The provinces need to re-orient their education policies.

> However, the provinces themselves can be far less constrained in that reorientation if they move at the same time and roughly in the same direction. Helping them to do so is the role the central government should seek to play, and, in order to play it, the old work horse of federalism, the federal-provincial cost-sharing agreement, may yet come back into favour.

A move towards national standards?

None of these commentators on education was proposing federal action to achieve or to impose national standards in the sense they were discussed in relation to health care. In fact, the only one to refer to the issue was M. Forget, and he did so only to denounce the idea:

> Another temptation that may lure some Ottawa minds is that of superimposing newly devised 'national standards' on the educational component of EPF. I believe, however, that the spending power could not make binding any federally conceived standards beyond some dealing with entitlements to educational programs – in other words, with 'who gets what' questions. Except for accounting requirements, Canada has no experience with national standards of substantive content that have successfully gone beyond those simple, albeit at times far-reaching, rules. Should an attempt be made, it will be shot down.

This distinction between 'entitlements to educational programs' and 'national standards of substantive content' is interesting, however, because it is exactly the distinction I emphasized earlier. Evidently, in the case of health care, the federal government is forcing the issue of entitlements; the question is whether, in that area, it may also be broaching, implicitly and tentatively, the issue of substantive content.

In a sense, it may be closer to doing so in the case of postsecondary education than in the case of health care. Ottawa is not discernibly contemplating the supervision of the quality of instruction or the

monitoring of diploma standards. On the other hand, as noted by Messrs. Dobell and Ryan, this year's amendments to the EPF arrangements (Bill C-12) require the Secretary of State to report annually to Parliament on the size of the federal fiscal transfer for postsecondary education, and the level of provincial spending. In addition, the act requires that the report include:

> – any other federal programs of support to or involvement in post-secondary education;
> – the relationship between such federal contributions, transfers and programs and Canada's educational and economic goals; and
> – the results of any consultations . . . [with the provinces] relating to the definition of national purposes to be served by post-secondary education and the means by which the governments of Canada and the provinces will achieve those purposes. (Bill C-12, Section 9)

In fact, federal spokesmen have been showing increasing inclination to formulate specific national objectives in the field – an inclination that was completely absent as recently as five years ago – and, as Mr. Cameron mentioned, to complain about the provinces' making cutbacks or grant increases that are below the rate of inflation, while the federal contribution under EPF grows and grows.

Such statements suggest that federal politicians and officials may be contemplating reintroducing conditionality in two senses: (1) making the size of the transfer depend on the content of educational programming; and (2) making the size of the transfer depend on the magnitude of provincial spending in the field. Granted, what the federal government seems to be considering is measurement not of provincial performance but of provincial financial effort and its direction to designated programs, but the suggestion of national standards is there all the same. It would not be the first time that an input measure, rather than a performance yardstick, has been used to gauge quality.

Of course, the federal government has available another way of achieving standardization in the kinds and quality of services provided to the public. It can devise its own distinctive programs, even if responsibility for their administration is devolved upon the

provinces (as in the case of the Canada Student Loans program, for example).

Some of the conference discussion on postsecondary education, especially that by Mr. Cameron and Dr. Slater, seemed to imply the possibility of shifting away from fiscal transfers (which are a means of buying policy influence in a provincial field) towards distinct federal programs in which control would not be shared with the provinces. Candidates for new or expanded federal programs might be research support, student aid, institutional subsidies for specific programs, such as technological training, and 'adaptation' grants (analogous to research grants) to facilitate innovation within a mature higher-education system.

The question, not discussed in this conference, is whether such direct action by the federal government – which might entail reducing fiscal transfers to the provinces – would be preferable to conditional grants. The conditional grant is a device by which the federal government subsidizes an activity that in constitutional law is within the exclusive jurisdiction of the province. The principle of provincial exclusivity is infringed whenever a shared-cost program is set up because the availability of a subsidy generally creates enormous pressure on the provinces to accept the subsidy and provide the service. Indeed, the whole point of a conditional grant is to induce the provinces to modify their expenditure priorities and/or to adapt the design of their programs to contribute to the fulfilment of federal objectives.

The paradox (or perhaps the federal miscalculation) involved in the 1977 EPF arrangements was that Ottawa expected to retain policy influence while it withdrew the financial incentives upon which its influence had historically depended. As Mr. Dobell pointed out in his comments on Bill C-12, by separating the health-care and the postsecondary-education components of the fiscal transfer under EPF, the federal government has now opened the door 'for the introduction of conditions designed to promote the achievement of "national" (federal) objectives or standards in postsecondary education'.

INCOME SECURITY

The field of income security differs from those of health care and postsecondary education in that the most expensive programs in it

are federal ones. The importance of fiscal transfers to the provinces, with varying kinds and degrees of conditionality, is correspondingly less. As Keith Banting noted, if one measures only the payments to recipients and ignores all intergovernmental transfers involved in financing the benefits, 'Ottawa pays out at least 75 per cent of all income-security dollars, a figure that has been remarkably stable for almost two decades'. The main provincial program is social assistance, of which the federal government pays half under the Canada Assistance Plan (CAP). If the calculation includes federal transfers under CAP, Ottawa finances 85 per cent of expenditures on income security.

Michael Mendelson proposes that the federal government withdraw from cost-sharing of provincial social-assistance programs and move directly into the area, making its own income-related payments, which could be topped up by any provincial government that desired to do so.

A move towards national standards?

Mr. Mendelson's proposal would be one way of achieving national standards – not uniform ones, but minimum ones that the individual provinces could supplement in varying degrees. At present, the CAP provides a level of assistance that is negotiated individually with each province and is not a vehicle for the implementation of national standards. Federal cost-sharing under the CAP, Professor Banting noted, 'has encouraged expansion and consolidation of provincial social-assistance programs', though the CAP does have 'outer limits [that inhibit the provinces' attempts] to supplement the incomes of the working poor and to expand social services'. On the other hand, some provinces have proceeded with income supplementation for the working poor without cost-sharing.

The difference, then, between the present arrangement and the scheme proposed by Mr. Mendelson is that a basic federal program would establish minimum national standards or entitlements without requiring the provinces to make any contributions to implement them. But because of probable provincial supplementation of the federal plan, levels of assistance would probably continue to differ from one province to another.

EQUALIZATION, NATIONAL STANDARDS, AND PROVINCIAL PREFERENCES

If national program standards are the goal, the preceding comments suggest four approaches to achieving them.

1 The federal government can subsidize designated provincial services through a shared-cost program. The availability of 'fifty-cent dollars' (if cost-sharing is on an equal basis) constitutes an inducement to spend money in the area. Ottawa can set implicit norms through the definition of the items eligible for subsidy (for example, support levels under the CAP), but the only penalty to a province for operating below the norm is that it forgoes part of the potential subsidy. A province may, of course, also provide unsubsidized services.

2 The federal government can transfer fiscal resources (cash or tax points plus cash) to the provinces using a formula such that the size of the transfer is unaffected by program costs or by levels of provincial expenditure. The model here is the 1977 EPF scheme, in which program standards were left entirely to the provinces. On the other hand, in the case of health-care programs, a province's eligibility for the transfer did depend on program design (notably, on meeting the universality criterion, which stipulates citizens' entitlement to whatever services the province provides).

3 In a variant of the preceding, the federal government can set program standards and monitor the quality of services provided by the provinces, imposing penalties (reduced subsidies) for substandard performance. As I have emphasized, this is not being done now and has not been done historically in Canada. The Canada Health Act, however, may offer the potential for formulating and imposing national program standards, and several conference participants referred to the possibility that the federal government may contemplate introducing them.

4 The federal government can legislate national standards by setting up a basic program of its own with the possibility that provinces may establish their own programs as supplements. This is the scheme proposed by Mr. Mendelson for social assistance; it already exists in some other areas, such as agricultural-production subsidies, research

grants, and industrial assistance; provinces may top up a basic federal grant by operating their own programs in parallel with the federal one.

Equalization is a fifth way of establishing national standards in areas of provincial jurisdiction, exclusive or concurrent. The four avenues already discussed involve varying degrees of respect for provincial autonomy, of financial pressure on the provinces, and of federal supervision and control. Compared with these four, equalization is least constraining on the provinces, but it is also least effective in ensuring minimum levels of service across the land.

The conference discussion of equalization did not deal explicitly with the issue of national standards. Nonetheless, the purpose of fiscal equalization is to make possible the achievement of interprovincially comparable levels of public services without setting national norms and without imposing penalties on a province whose policies are out of line with the others'. Attention to this aim is basic to evaluating any formula. Indeed, the role of equalization in contributing to the achievement of national standards while avoiding uniformity in program design did implicitly underlie participants' evaluation of the present formula by the criteria of equity, contribution to nation-building, fiscal soundness, political acceptability, efficiency, and facilitation of decentralization. It is useful to review some of the discussion of these issues and then return to the more general theme.

Equity and nation-building

A number of speakers referred to the equalization clause of the Constitution Act, 1982 which commits the federal government to

> making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation (s.36c2)

This principle was initially formulated, though in slightly different language, by the Rowell-Sirois Commission (Royal Commission on Dominion-Provincial Relations 1940). It underlay the Commission's proposal for a system of 'national-adjustment grants', still the most

comprehensive scheme of equalization ever to have received official attention in Canada. The proposal, according to Peter Cumming, made explicit a principle that had been implicit in Canadian federalism from the start, the principle of equitable fiscal federalism. 'A core value of fiscal equity underlies the concept of Canada as a federal state', he said. The point is essentially the same as the one quoted earlier from Mr. Johnson – that it is part of Canadians' political ethos to share wealth and income with each other.

Professor Cumming's criticisms of the present equalization scheme were based on its incomplete realization of the principle of fiscal equity, which, in turn, was supported on explicitly nation-building grounds. Professor Courchene, whose views as expressed in his paper on equalization otherwise differed sharply from Professor Cumming's, concurred in this respect:

> The nationhood argument is based on the notion that there are certain types of public goods and services to which all Canadians should have access as a right of citizenship. . . . Some economists interpret this rationale in terms of the public-finance notion of horizontal equity, but I prefer the emphasis on nationhood.

Although the principles of equity and nation-building are undoubtedly linked in practice, it is unfortunate in a way that they were virtually equated with each other (Professor Courchene) or that the one was seen as instrumental, the other basic (Professor Cumming). In fact, they suggest quite different criteria for judging the adequacy of an equalization scheme. The equity criterion is satisfied when provinces have the capacity to provide comparable levels of service at comparable levels of taxation, even if some choose not to do so (implicitly preferring to let their residents take a relatively larger proportion of their real incomes in the form of privately supplied goods and a relatively smaller proportion in the form of publicly supplied goods).

The nationhood criterion, by contrast, requires that equivalent or nearly-equivalent fiscal capacities be translated into government services. A neat formulation of the latter idea is implicit in Mr. Ryan's statement:

> In every year, the subsidy level [for provinces receiving equalization] must be in line with the level of disparity among the various provinces and with a generous view of what the quality of public services offered in all provinces of the country should be.

The nationhood argument suggests, paradoxically, a more demanding standard for equalization. One can argue that the equity criterion is satisfied when the poorer provinces are brought up to the national average or to some other conventionally adopted standard. Moreover, certain sources of revenue – again, by convention – may be regarded as exempt from equalization. For example, revenues from nonrenewable resources may be partially or wholly disregarded on the grounds that constitutionally entrenched property rights are sacrosanct, that these revenues are a hedge against future losses in income as a resource is exhausted, and so on. The nationhood argument, however, with its foundation in notions of citizenship, may be less likely to bend to the exemption of certain revenue sources, and it is more likely to be used to try to 'level down' above-average incomes from any source.

I sense that these differences stem from the thought that citizenship demands equality of sacrifice as well as equality of entitlement. Perhaps I read too much into the fact that both Professors Courchene and Cumming stress the nationhood argument over the equity argument. Nevertheless, it is interesting to note that the one proposes an interprovincial pooling of resource revenues to fund part of the equalization program, and the other suggests a constitutional amendment to ensure that, one way or another, the means are available to implement, comprehensively, the principle of equalization as enshrined in the Constitution.

Fiscal soundness and political acceptability

No equalization formula can be so generous that it bankrupts the federal treasury. Consequently, the fiscal soundness of former, existing, and possible future equalization schemes received considerable attention from conference participants. They also recognized that too generous a scheme, besides being fiscally irresponsible, would be politically unacceptable. It would be unacceptable to the federal government, which foots the bill directly,

and unacceptable to the wealthier provinces – mainly Ontario – whose taxpayers ultimately fund the scheme through the federal treasury.

The principles of fiscal soundness and political acceptability received attention, however, less as objectives in their own right than as practical considerations that limit the application of the principles underlying the idea of equalization (mainly the equity and the nationhood arguments). Two questions were implicitly put. The first was: to what degree do we have to compromise the principles of equalization to get a scheme that is financially and politically viable? And the second: can the formula be recast so as to achieve fuller implementation of the underlying principle without undue financial or political cost?

We did not get good answers to these questions; indeed, it would have been futile to expect it. Here is a classic case of trade-offs that, it seems, ingenuity can do little to resolve. Fully meeting the objectives of equalization without unduly burdening the federal treasury would require constitutional innovations that would be unlikely to be politically acceptable.

At the root of this problem lies the grossly unequal division of resource revenues. In principle, there are two solutions: (1) to have the provinces finance the equalization payments directly, or (2) to give the federal government an expanded capacity to tap resource revenues. For ten years now, we have lived with federal-provincial disputes on the latter subject, and it is difficult to imagine further concessions being made by the resource-producing provinces or, more to the point, further federal claims being made good by fiscal aggression. The prospects for direct interprovincial sharing are, in my opinion, at least equally remote. To satisfy the understandable nervousness of the recipient provinces, such a scheme would have to be negotiated and constitutionally entrenched. The mind boggles.

Efficiency and decentralization

The conference's discussion of fiscal equalization also focused on the interrelated themes of efficiency and decentralization. What level of equalization and what formula will do the most to promote efficiency in the allocation of resources (or the least to detract from it)? The question was posed by Professor Courchene, who reiterated his earlier-expressed opinion that if one considers only the direct

impact of equalization, its negative efficiency effects predominate. He added, however, that equalization makes it politically feasible to decentralize responsibility for public services; since decentralization fosters cost-cutting through program innovation and experimentation, equalization may be presumed to contribute indirectly to efficiency, though to a degree that cannot be quantified.

I think the question to be asked here is *how much* the recipient provinces dare to rely on equalization to provide them with the fiscal means for bearing expensive social responsibilities. The principle of equalization has been entrenched in the Constitution, but in necessarily vague language that permits modification of the formula whenever its effects – mainly, the size of the burden on the federal treasury – become politically unacceptable. Any province that receives considerably more revenue from equalization payments than from the income tax (as is the case with all four Atlantic provinces) can be expected to be nervous about relying too heavily upon equalization: a change in the formula could have disastrous effects on its revenue structure. The federal government has routinely made transitional payments to provinces that lose revenue as a result of changes in the fiscal arrangements, but those payments merely dampen the immediate effect. The larger the share of equalization in the provincial revenue structure and the larger the share of equalization in the federal expenditure structure, the more nervous are those governments most heavily dependent upon the scheme.

A remark in Professor Banting's *The Welfare State and Canadian Federalism* (1982: 105) places the issue in perspective: the interprovincial transfers accomplished within the federally funded social-security system are as great as the transfers made through the equalization program. Thus, for the 'have not' provinces, financial security lies as much in direct federal assumption of the most expensive program responsibilities as in equalization. Professor Courchene is undoubtedly correct in noting that we would have to have a much more centralized state in the absence of equalization, but there are limits to the degree of decentralization that equalization allows.

In brief, decentralization exposes the poorer provinces to financial risk from possible changes in the formula, and it imposes a cost in the sense that no politically acceptable and financially sound scheme of equalization can fully compensate for the financial burden involved

in providing public services. Equalization alleviates the recipient provinces' budgetary problems, but even so, the wider their program responsibilities, the heavier their fiscal burdens relative to those of the wealthier provinces.

EQUALIZATION AND NATIONAL STANDARDS: A REPRISE

Each of the topics raised within the broader discussion of equalization brings us back to a single theme: the achievement of national standards in public services while avoiding uniformity and rigidity in program design. Equalization evidently falls short of its objective of achieving interprovincially comparable services with interprovincially comparable tax effort, but it comes as close to achieving this twin objective as is fiscally sound and politically acceptable, given the extent of the provinces' program responsibilities. And it does allow a degree of decentralization that would be impossible to achieve in the absence of a general, unconditional transfer scheme.

The fundamental questions, however, remain unanswered. How far do we want to go towards defining and implementing national program standards? Do the fiscal arrangements, a package including both a general-purpose transfer (equalization) and specific-purpose transfers for health care, postsecondary education, and income security, take us just the right distance along this road? I have already noted tendencies towards more federal involvement in the definition and implementation of national standards in the three major policy fields. There are political forces, arguably supported by economic-integration reasoning, that tend to drive us further along the road, and there are countervailing political forces, supported by economic-efficiency reasoning, that would drive us back in the opposite direction. My own sense, reinforced by my reading of opinion at the conference, is that these countervailing forces are probably weaker now than they were, say, in the 1960s.

THE ACCOMMODATION OF DIFFERENCES

The original rationale for an equalization program, as formulated by the Rowell-Sirois Commission, was that it could accommodate quite different public philosophies in different provinces. The Commission condemned shared-cost programs as federal interference in the

delivery of public services within provincial jurisdiction. On the other hand, it saw unconditional transfers, based on fiscal need, as essential to preserving the autonomy of the poorer provinces. After all, that autonomy, supporting regionally distinctive communities, could be nothing but a sham for any province lacking the fiscal resources to exercise its constitutional powers.

The Commission apparently thought that if every province were assured a financial base adequate to provide services up to the national average, political pressures would ensure that this result actually obtained. Yet it would be a result achieved through political processes internal to the province, not one imposed upon it by the federal government.

> It should be made clear that while the adjustment grant proposed is designed to enable a province to provide adequate services (at the average Canadian standard) without excessive taxation (on the average Canadian basis) the freedom of action of a province is in no way impaired. If a province chooses to provide inferior services and impose lower taxation it is free to do so, or it may provide better services than the average if its people are willing to be taxed accordingly; or it may, for example, starve its roads and improve its education, or starve its education and improve its roads – exactly as it may do today. But no provincial government will be free from the pressure of the opinion of its own people. (Royal Commission on Dominion-Provincial Relations 1940, 2:84)

It must have seemed reasonable to suppose that the provinces with the greatest fiscal capacities would set the standards for the provision of public services, and that the other provinces, pressured by their electorates and fiscally supported by the adjustment grants, would follow. In this way, something approximating national standards would be set, though with the federal government limited to a facilitating role through fiscal redistribution.

The situation today is nothing like that vision. It is the provinces with the greatest fiscal capacities – Alberta, British Columbia, Ontario – that are showing the greatest proclivity to pare away earlier-established standards in public services. The federal government shows ever-increasing inclination to define national

standards and to impose them upon all provinces with a set of fiscal inducements and penalties. In the past, it supported the extension of services by launching a series of shared-cost programs; then, with EPF, it made program costs irrelevant to the size of the transfer, relying on electoral pressures – and in the health-care field, broadly stated legislative conditions – to maintain existing services without any slippage in standards. Now it appears to be contemplating alternative ways of reasserting and extending its policy influence:

– Reintroducing a link between the size of provincial expenditures and the size of the fiscal transfer.
– Legislating standards and imposing financial penalties for noncompliance or substandard performance.
– Implementing distinct federal programs to complement provincial ones or to provide a basic standard, which provinces may top up as they see fit.

These are three different ways of saying equalization is not enough.

At this conference, the most impassioned attack on this tendency came from Mr. Stanfield. Though 'Canada is a country of regions' is a banal phrase, Mr. Stanfield, in his paean to diversity, filled it with such conviction that it burst upon us, resonating through a hushed hall. Where others criticized the rigidities and inefficiencies that result from federal control of provincially supplied public services, Mr. Stanfield spoke out his belief that the geographic concentration of political power is fundamentally wrong and must be reversed. Ottawa's economic powers are already too extensive, and they are usually exercised in a regionally discriminatory way. An unfettered federal spending power is incompatible with the division of powers, for the provinces have spending priorities that are as important as Ottawa's. Federal interference with provincial programs not only fosters inefficiency and irrationality in the delivery of public services; it is *illegitimate* and must not be tolerated.

Moved as I was by Mr. Stanfield's address, I couldn't repress the thought that the views he expressed are now out of sync with Canadian public opinion. Though the conference participants were scarcely a representative cross-section of Canadian society, it nonetheless seemed telling that the emphasis throughout the conference was on levels of public services roughly equivalent from

province to province, on rationality of program design, and on flexibility and adaptability in delivery systems. One's sense that homogenizing forces are at work is reinforced by data from opinion surveys, which demonstrate that regional differences in policy preferences are diminishing over time; when shifts occur, opinion moves in the same direction in all regions (see Simeon and Blake 1980: 99-103). Increasingly, Canadians seem to believe that citizenship involves entitlement to services that do not vary significantly from province to province. The Charter of Rights will encourage this tendency. National standards count. Diversity in techniques for achieving shared purposes or similar objectives is also an advantage, but it is a subordinate consideration.

Is this the mood of the country? Perhaps yes, perhaps no. Be that as it may, it is evident that Canadians are making fundamental choices about citizenship when, through the adaptation of the fiscal arrangements, they almost continuously redefine the respective policy roles of federal and provincial governments. The distribution of money goes a long way towards determining the extent to which there will be national standards in public services. And in implementing a preferred distribution of money and power, Canadians do much to establish a preferred relationship between national and regional political communities.

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Some political realities in the world of stagflation

Douglas G. Hartle

Many of the speakers at this conference emphasized that, given the intermediate-term economic outlook, prevailing economic conditions are likely to have a significant impact on federal-provincial fiscal relations in 1987, the year the current Established Programs Financing Act is to be renegotiated. For example, Tom Courchene, in his thoughtful, tone-setting opening paper, pointed out that the new, stringent circumstances characterized by 'slowth' (slow growth) are likely to mean that fiscal relations are economically determined, rather than determining. It is most important, in his view, that attention be directed primarily to revising the fiscal arrangements so as to minimize any adverse economic effects they might have.

Richard Simeon said that fiscal stringency 'plausibly . . . may either exacerbate or diminish regional and intergovernmental conflict'; the emphasis he placed on the economic environment suggested that, one way or another, it is likely to be a major consideration. Rod Dobell drew attention to the 'growing tensions between federal and provincial governments in a struggle to increase revenues and shed responsibilities' in the fiscal restraint in the decade ahead. Robert Stanfield, in the concluding passage of his evening address, expressed the hope that Ottawa would not use the perceived need for fiscal restraint 'to shoot regional demons'. Several of the authors of other papers that dealt with particular program areas – medicare, postsecondary education, and social security – explicitly or implicitly

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put the demand (need?) for fiscal restraint at the centre of their analysis. There is good reason, therefore, to take the probable impact of fiscal restraint on federal-provincial fiscal relations to be the major theme of the conference.

FISCAL RESTRAINT AND THE FEDERAL DEFICIT

Because the federal deficit is of overriding importance to this major theme and because the conference did not consider its causes and 'cures', I am going to start my remarks by exploring this extremely controversial subject more extensively than would normally be warranted in a commentary such as this.

Economic realities

It is not necessary to review in detail the salient facts concerning current economic conditions in Canada. Although a modest recovery has been under way for about a year, the economy is still painfully weak. Unemployment remains at about 11.5 per cent; inflation has moved up to more than 5.0 per cent annually; real interest rates are at unprecedented levels; the Canadian dollar is below 76 cents U.S. and has had to be supported by the monetary authorities; productivity improvement has been negligible for years (at least as measured) and seems likely to remain shockingly low, especially relative to that of some of our international competitors; the world prices of our principal resource exports are weak; business' fixed-capital formation has not rebounded; the annual federal deficit is running at around $30 billion and declining only slowly.

The sorry state of the world economy is no doubt partly – probably largely – to blame. It, in turn, is directly or indirectly explicable in terms of three phenomena: the problems of adjustment (or lack of it) to the dramatic increases in world oil prices; the overextension of loans to Third World countries, some of which cannot meet their debt-service costs because prices for their export products are so low; and the extraordinarily high value of the U.S. dollar resulting from high interest rates in the United States. High U.S. interest rates are the immediate reflection of a rapid expansion of that country's economy and its recent stringency in monetary policy. They are also explained by a massive U.S. deficit, which portends either crowding out by growing private investment or inflation should Washington

loosen monetary policy in an attempt – which probably would prove unsuccessful – to keep interest rates from rising further as the November 1984 presidential election approaches.

That the recent modest buoyancy in the Canadian economy has been largely attributable to the rather frightening strength in the U.S. economy goes without saying. If the U.S. economy continues to expand, Canada will no doubt continue to be carried along. However, it is important to note that although Canada once prided itself on at least marginally outperforming the United States in terms of the 'misery index', during the last half-decade the Canadian performance has been the worse by more than a small margin.

The complex reasons for this apparent failure of Canadian policy are beyond the scope of this commentary. One partial explanation is the plethora of barriers to economic adjustment that our governments have created for short-term political purposes. These rigidities stifle incentives and inhibit the efficient allocation of resources with consequent reductions in potential output and increases in the size and duration of the shortfall from that potential. Such government intervention arises in response both to demands by narrow interests for rent-yielding monopolies and to demands for protection against losses that would otherwise result from market changes.

Mancur Olson (1983) theorizes that nations, such as Canada and Great Britain, that have not been disturbed by lost wars or revolutions in recent times are more susceptible to these inhibiting economic rigidities than are countries, such as Germany and Japan, that have been swept by such cataclysms. He reasons that in the former kind of nation, the decision-making structure, which is inevitably dominated by interest groups, becomes calcified with age and incapable of adjusting quickly to take advantage of opportunities and to absorb difficulties.

The United States is an apparent exception. During the last recession, it showed its ability to stand fast in the face of negative shocks with only minimum government cushioning; unemployment soared, but transfer payments in cash or kind to low-income individuals and families were cut back. Such measures – more accurately, non-measures – drove real wages down further and faster than the simultaneous Canadian policies, which did not weaken and

perhaps strengthened the safety net. Why this occurred deserves examination – but not here.

Recognition must be given here, however, to the possibility that federal-provincial fiscal relations are a factor contributing to the increasing sclerosis of Canada's economic system. The agreements, although they are not necessarily financed by taxing rents, can create rents that are understandably defended with great vigour and often at great cost. Increased government involvement, via shared-cost programs, in health care, higher education, and training has probably created more rigidity in these fields than prevails in the United States with its much greater reliance on private provision with direct subsidies to individual beneficiaries. At best, the agreements run for substantial periods and probably increase the inevitable adjustment lags.

The federal deficit

The U.S. federal deficit is currently running at about $200 billion annually, and the Canadian at about $30 billion (the figure for each country being expressed in its own funds). A rough-and-ready rule of Canadian-American proportionality is 1:10. Thus, if the U.S. deficit were proportionately the same as the Canadian, it would be $300 billion rather than the alarming $200 billion it is.

For those who take a balanced budget as *the* criterion for assessing governmental prudence and efficiency, the Canadian fiscal situation is decidedly worse than the American. From a perspective that is more meaningful (at least in the context of impending federal-provincial fiscal relations), the Canadian deficit is, however, less frightening than the proportionately smaller U.S. deficit. This statement requires some important explanations.

Commentators have been distinguishing in recent years between the structural and the cyclical components of government deficit. The cyclical component, as the term suggests, is that part of the deficit explicable solely because the economy is operating below its potential. Output does not grow as fast as it could (it may even decline) and unemployment remains high or rises. The failure of output to expand means a slowdown or decline in the growth of revenues because income and sales, the major tax bases, also grow more slowly or decline. The rise in unemployment increases expenditures on unemployment and welfare benefits. With the

government's revenues down and expenditures up, the cyclical deficit comes into being and spirals upward as debt-service costs also rise. In this analytical framework, the structural component of the deficit is a kind of residual: it is what is left when one subtracts the cyclical component of the deficit from the total deficit. Put slightly differently, the structural ('permanent') deficit is the deficit that would exist even if the economy were functioning at its potential (stable prices and full employment).

The consensus among competent analysts is that the U.S. deficit is predominantly structural, but the proportionately larger Canadian deficit is largely, though not entirely, cyclical, and thus most of it will gradually disappear as the country achieves full employment of labour and capital. As Canada's unemployment rate and interest rates have remained high, analysts have raised their estimates of the structural component of its deficit, but they are still well below the proportionate estimates for the United States.

This difference in the diagnoses of the Canadian and the U.S. situations has some important policy implications. The United States' deficit had a massive and timely stimulating economic effect that no doubt largely accounted for that country's recent strong recovery. In the trough, whose depth was unprecedented since the 1930s, heavy government borrowing was not matched by large increases in the money supply, but the result was not crowding out and an attendant increase in interest rates because there was so little demand for finance from the depressed private sector. Since the recovery, the U.S. economy has required less fiscal stimulus. Yet reducing the deficit would mean *politically* costly tax increases or expenditure cuts, so it remains undiminished and, indeed, is forecast to continue to rise. This situation tends to put upward pressure on U.S. wages, prices, and interest rates. High U.S. interest rates attract funds to that country, pushing up the value of its dollar against other currencies (thus stifling U.S. exports and encouraging U.S. imports).

A rising value for the U.S. dollar simultaneously pushes down the value of the Canadian dollar – unless the Canadian monetary authorities intervene. And intervene they have: the Canadian money supply has been tightened in order to increase this country's interest rates almost (but not quite) *pari passu* with those in the United States and thus prevent a devaluation of the Canadian dollar *vis-à-vis* the U.S. dollar greater than the one that has occurred.

Although domestic employment badly needs the stimulation of a further fall in the Canadian dollar, such a devaluation would bring about a significant increase in the Canadian prices of imports and hence in the cost of living. This almost-certain inflationary effect has been judged, rightly or wrongly, by the Canadian monetary authorities to be not just an unfortunate side-effect but a disease that would be worse than the unemployment problem it would alleviate. Thus, real interest rates have soared to well in excess of 6 per cent – an unprecedented level in modern times. Their rise has deterred private capital expenditures. The result has been a weak and precarious Canadian recovery.

Ottawa's macro-policy dilemma lies in the fact that cutting the Canadian dollar free of the U.S. and allowing it to decline would at first permit a more expansionary monetary policy with a resulting decline in interest rates. But the increase in the price level following from such a devaluation would likely raise inflationary expectations, which would soon be reflected in higher interest rates. Moreover, with inflation rates higher in Canada than in the United States, the value of the Canadian dollar would probably continue to drift lower and lower, resulting in ever-increasing prices and nominal interest rates north of the border.

Reducing the Canadian federal deficit quickly and substantially, then, could be counterproductive. It is *not* federal government borrowing that is crowding out private borrowing and forcing up interest rates. Canadian interest rates are high because the Bank of Canada is tightening monetary policy in order to push up interest rates *almost* in lock step with the rise in U.S. rates. Reducing the federal deficit too soon and by too much would serve only to reduce aggregate demand with the result that unemployment would rise even higher than its current rate of 11.6 per cent. (A lower rate of increase in prices – currently more than 5.0 per cent annually – would presumably be a favourable byproduct.) Moreover, if the Canadian deficit is indeed substantially cyclical in nature, such a reduction would push the country's output even further below its economic potential and thus further protract the recovery – a recovery that by most accounts will be extremely slow and modest.

It would, of course, be in the Canadian interest if the United States were to reduce its deficit. Such a move would lower interest rates there and permit Canada to introduce a more expansionary monetary

policy and thus lower interest rates. But the point is this: although massive discretionary cuts in the U.S. deficit would help Canada, discretionary cuts of the same relative size in the Canadian federal deficit are probably not in the Canadian interest at this time. On the other hand, if the Canadian recovery continues under current policies, the large cyclical portion of the deficit will decline. Given even a modest real growth rate of about 3 per cent, it is likely that the Canadian deficit will be cut in half within five years.

Political realities

In political decision-making, however, reality is one thing and perceptions are another. The media and the public generally perceive the current Canadian federal deficit as scandalous – as reflective of bad management not only of the economy but of government itself. It is widely believed to be threatening national sovereignty and 'stealing' the inheritance of future generations. Thus, for wrong reasons, the need to reduce the federal deficit is likely to be an important, perhaps overriding aspect of stated federal policy in the near and intermediate term (say, five years), whether the Conservatives or the Liberals form the government.

How assiduously the next federal government will *actually* pursue deficit reductions (as distinct from making public pronouncements about its intentions of making deficit reductions) is an entirely different matter. However, to some extent this distinction is irrelevant to federal-provincial fiscal arrangements. In negotiations with the provinces in 1987, the federal bargaining position is likely to be dominated by the 'necessity' of reducing the federal deficit. Whether such a stance is inappropriate or not, contrived or not, the provinces are in all probability going to be confronted with the federal government's insistence that its fiscal transfers to them be reduced. What is more, this federal demand for deficit reductions via reduced fiscal transfers will be not only accepted by the public but strongly supported as long overdue. The chances are slim indeed that the public will identify reduced federal deficits with higher provincial deficits or higher provincial taxes or lower provincial expenditures.

Yet if the recovery is slow and hence protracted, the provinces' deficits in 1987 will be relatively large and persistent, as will their underemployment problems. Reducing federal transfers will, therefore, almost certainly entail not only more provincial borrowing

but also more provincial tax increases and more provincial expenditure restraint. The political costs of federal deficit reduction will thus be shifted, insofar as possible, to the provinces. In this situation, the fiscal 'negotiations' are bound to be extremely acrimonious, if not vicious.

Compounding the problem will be protectionist measures undertaken by the provinces to give at least the *appearance* of trying to solve regional and local unemployment problems. These nontariff barriers damage the Canadian economic union, and the federal government will rightly oppose them (although it is unlikely to admit their indirect partial responsibility for the underlying problem). Yet since the federal government has no constitutional basis for fighting such barriers other than the weak and narrow labour-mobility provisions of the Charter of Rights, its only ways of preventing them are through constitutional amendment or through persuading the provinces to adopt something like Tom Courchene's 'code of economic conduct'. As Michel Robert showed the conference, constitutional amendment is well-nigh impossible of achievement. And since a code would remove some of the policy instruments now at the provinces' disposal without replacing them with anything, it is difficult to see why they would accept it willingly. Neither is the federal government likely to be able to force it on them. The spectre of the deficit would probably make it impossible for the federal government to 'bribe' them to accept it, and public support for the economic union is probably insufficient to justify the 'punishment' of provinces that erect barriers that Michael Trebilcock suggested.

This, then, is the economic and public-opinion climate to be expected in 1987 fiscal negotiations. It bodes ill for the tolerance and civility in the face of adversity that Richard Bird called for in his luncheon address.

Professor Simeon, in his discussion of the 'politics of restraint', found some potentially countervailing forces. On the negative side, he foresees:

– 'Scarcity promot[ing] fragmentation and exacerbat[ing] conflict along all dimensions because it highlights tensions over the distribution of income'.
– More aggressive competition among provinces for scarce development and tax dollars.

On the positive side, he thinks that:

– The division may be between capital and labour rather than between regions.
– The electorate may view the federal government as possessing 'the greatest potential for dealing with the problem' (if it is not seen to be too constrained by international forces).
– Both levels of government may be anxious to avoid the costs of conflict because of public perceptions that the country cannot afford them.
– Conflict may be reduced because governments will not be expanding their involvement in the economy and society.

Professor Simeon concluded this part of his paper with the comment: 'Thus, scarcity and restraint may have ambiguous effects on the salience of interregional conflict. To the extent they recast politics in a more class-based mode, regional conflict will be muted.'

One cannot but hope that Professor Simeon was not being overly optimistic. I think he was. More emphasis on the division between capital and labour does not necessarily mean less federal-provincial conflict because interest groups will use either level of government to fight their battles with the other. And although most voters are no doubt exasperated by the costs of federal-provincial conflict, they have little if any means of bringing that annoyance to bear on the proceedings. Referenda on federal-provincial issues are extremely rare; such issues are seldom the principal focus of elections at either level of government. Has not the public, especially the public outside Quebec and Alberta, always had a high degree of antagonism towards federal-provincial antagonism?

ASPECTS OF FEDERAL-PROVINCIAL FISCAL RELATIONS

Given this extended background, I will now try to discuss some relatively concrete issues with respect to each of the major aspects of federal-provincial fiscal relations. I will make no attempt to summarize the conference papers, much less critically assess each of them. For the sake of brevity, I will proceed in point form.

Equalization

1 Explicit equalization payments emerged in Canada in 1957 when the wartime tax-rental agreements were replaced by the tax-collection agreements. Some analysts argue that the rationale for introducing these equalization payments derived from the Rowell-Sirois Commission's argument for 'national-adjustment grants' (Royal Commission on Dominion-Provincial Relations 1940). However, Robert Bryce, one of the federal officials involved in the negotiation of the tax-rental agreements, told me that some implicit equalization was built into those arrangements in 1940 in order to provide the poorest provinces with revenues sufficient to meet their interest obligations. Several provinces were about to go bankrupt, and Alberta had already done so. Ottawa feared that more provincial bankruptcies would jeopardize future federal-bond issues needed to finance the war effort. Having once granted these transfers to the provinces, the federal government could not politically withdraw them in the postwar tax-collection agreements because its revenues were so high and its constitutional spending obligations so limited in peacetime.

This story provides evidence that theory, in this instance as in many others, later rationalized practice.

2 We have recently heard renewed debate about the efficiency of equalization payments. Courchene (1984) emphasizes their inefficiency effects; Boadway and Flatters (1982) argue that equalization reduces costly and inefficient rent-seeking mobility. As Courchene stated in his paper on equalization at this conference, both arguments have some limited validity. If the taxes used to pay for equalization are on rents and only create rents, equalization that forestalls rent-seeking costs is desirable. But there is no assurance that the federal taxes that finance equalization in Canada come only from rents. Indeed, at the relevant margins, they do not apply to rents. Insofar as equalization induces tax-avoidance (or subsidy-obtaining behaviour), it reduces allocative efficiency.

There seems, however, little reason to give much weight to the economic-efficiency aspect of equalization in a world replete with other sources of inefficiency. The theory of the second best tells us that only in an otherwise perfect world does it unequivocably make sense to remove a market imperfection, inherent or government

made. One can plausibly argue on efficiency grounds that equalization is needed to offset the inefficiencies created by tariffs and similar measures that artificially aid the economies of the 'have' provinces. One can also argue that equalization is no worse an imperfection than regional or seasonal variations in Unemployment Insurance benefits or industrial subsidies geared to regional development, to cite but two examples. Why eliminate equalization unless measures that are equally or more distorting of resource allocation are also removed?

3 For the most part, federal-provincial fiscal relations have been negotiated from federal strength and provincial weakness. Since the federal government has often had the constitutional right to have its way or the fiscal means to bribe the provinces, many 'agreements' have essentially been little more than unilateral declarations by Ottawa. Yet only Quebec and Alberta residents seem ready to provide public support for provincial 'intransigence'.

The inclusion in the 1982 Constitution of the right to 'reasonably comparable' equalization may provide the provinces with a much-needed fulcrum for leverage. By appealing to the courts (or threatening to do so), the provinces may have a bargaining counter that they can use in negotiating other aspects of fiscal relations. In the likely fiscal climate of 1987, the appropriate adage would seem to be 'any port in a storm'.

Shared-cost programs

1 In considering the likely fate of federal-provincial shared-cost programs, it is important to remember the stake that *some* ministers and *some* officials now have in them. In the internal politics of the cabinet and the bureaucracy, the committed single-issue advocates may get their way by log-rolling with other ministers and bureaucrats who are willing to trade support for issues of shared-cost programs in return for support on unrelated issues.

2 Many of the shared-cost programs may have had their origins in the strong commitment by some ministers and officials to equality as distinct from equity. Egalitarianism achieved by in-kind transfers is probably more easily sold to colleagues and the public than

egalitarianism achieved by transfers of money income. Are 'national standards' but a disguise for egalitarianism?

3 Shared-cost programs have been a political gold mine for the federal government. It has received:

- Credit for 'forcing' the provinces to introduce them.
- No blame for capping them when expenditures grew 'too rapidly'.
- Credit for trying to 'reform' them – at least insofar as the Canada Health Act is concerned, and the reform of postsecondary education is likely to come, as David Cameron told the conference.

Moreover, the provinces have been forced to bear the political costs of raising taxes, cutting back services, and battling higher payments to members of powerful professional groups, such as physicians.

4 By including in the Canada Health Act penalties for provinces that permit extra billing by physicians, the federal government has put a straitjacket on the provinces, restricting their scope for efficiency gains in medicare that could have been used to offset the costs of compensating losers in a time of expenditure stringency. Without efficiency gains, such compensation, if any, will just add to provincial costs. (This statement is but another way of putting Professor Courchene's point about favouring efficiency, decentralization, and privatization.)

5 Frank T. Denton and Byron G. Spencer showed the conference that, from a strictly demographic point of view, education is one field in which future savings on expenditure are possible. To expect them, however, would completely ignore the pressure that is bound to be forthcoming from teachers and other groups to enrich and expand the educational system so as to use up – more than use up – these savings. It seemed clear from Mr. Cameron's remarks that the federal government will soon have new proposals for expansion in some areas of postsecondary education.

6 Michael Mendelson's paper emphasized what is almost always forgotten: possible savings in program administration are trivial, and other savings can be achieved only by converting some current

winners into future losers. 'Better' targeting of transfer programs does not produce some magical efficiency gain from which losers can be compensated. This is not to say that costs cannot be reduced (say, by rationalizing the current tax-expenditures and grants for children). What must be recognized is that rationalization will produce losers who cannot be fully compensated if there is to be any net saving.

7 William Watson's review of the arguments for pure private-market provision inadequately emphasized the problems associated with the woefully weak knowledge of health-care consumers and the seemingly pervasive public view that providing money to the poor is not an adequate method of providing them with the 'necessities', such as medical care, housing, and education. Paternalism is real, if irrational to the economist.

8 Greg Stoddart's excellent paper did not directly emphasize the federal-provincial-relations aspect of health care. As he said, 'The theme throughout this paper has been that the control of decisions affecting the production and utilization of health services must be linked with the responsibility for financing those decisions and services. . . . The underlying issue . . . is the locus of control for production and utilization [decisions].' Given that resources devoted to health care will always be limited, with the result that some people will always die or be sick who could have been alive or better, is it not imperative for politicians to obfuscate the final locus of decision-making responsibilities? Someone has to tell the patient that no dialysis machine is available: who wants to have to *appear* to have decided that the resources for it were diverted into highway construction?

Tax-collection agreements

1 Emphasizing that interprovincial competition and attempts at beggar-my-neighbour had created a tax jungle during the Depression of the 1930s, the Rowell-Sirois Commission (Royal Commission on Dominion-Provincial Relations 1940) recommended that the provinces vacate the income-tax field, corporate and personal. Although the wartime tax-rental agreements and the later tax-collection agreements virtually solved this problem of predatory interprovincial competition for taxes, there is a considerable risk that

the continuation of water-logged economic conditions and federal budget stringency will strengthen provincial demands for greater revenue, particularly if the burden falls on nonresidents, and greater protection via income-tax concessions. The favourable tax treatment British Columbia, with the acquiescence of the federal government, now accords its residents on certain types of B.C. bond interest is but one indication of the pressures that lie ahead. That some provinces are currently considering establishment of a separate personal income-tax system is ominous.

2 Professor Courchene emphasized the desirability of working towards a 'code of economic conduct' under which the provinces would agree to restraints against internal economic barriers. While obviously laudable in purpose, such voluntary measures have an inherent weakness: those who cheat often obtain an advantage that is difficult to detect or punish. Nontariff barriers are complex and subtle. Who is to determine when the code has been breached? What sanctions would be imposed? Would adverse public opinion be a sufficient deterrent? It is difficult to imagine local voters being upset by more local protection. Professor Simeon's suggestion of establishing an internal arrangement like that of the General Agreement on Tariffs and Trade (GATT) seems promising; the idea deserves further examination, at least as an alternative to a code. But GATT seems to have been largely ineffective in controlling nontariff barriers.

Process

1 Mr. Dobell's brief paper on consultation processes emphasized the special problems posed by slow growth, but he also drew attention to the fact that the tensions of the 1970s were induced in large part by the new prosperity Western Canada achieved through sharp rises in oil prices. In Mr. Dobell's view, such increases are not likely to recur before the next round or two of federal-provincial negotiations. He warned, however, that pressures from groups seeking protection against contracting social programs and rising health (and education?) costs 'seem to promise a more-than-adequate replacement for the previous regional tensions'. Consequently, he said, some groups in the provinces will make common cause with the

federal government against claims from provincial governments that they best reflect provincial interests, concerns, and priorities. He also predicted, as I have emphasized here, that the 1987 negotiations will likely be set against a background of severe federal fiscal stringency.

Picking up a view stressed by the Breau Task Force (Canada 1981), Mr. Dobell argued that Canadians are tired of the federal-provincial in-fighting characteristic of executive federalism. One method of defusing the conflict, he suggested, is the use of parliamentary task forces, perhaps on a mixed federal-provincial basis, that engage in open consultation with the public. The idea is that open and thorough discussion of the underlying economic and social factors, plus the development of a common information base, would make the negotiations less acrimonious because the inevitable gap between the parties is widened by mutual ignorance.

Certainly, it is impossible for any liberal-minded person to argue against improved public understanding and greater consultation. One cannot help but question, however, whether public dismay at endless intergovernmental bickering is likely to be translated into action. As the present system stands, majority governments of the day, both in Ottawa and in the provinces, all assert that they have mandates from their electorates to pursue a strong line against all the others – at least when doing so is expedient. The issue of federal-provincial fiscal arrangements is, at best, only one of a multitude of contending issues at stake in an election. A Quebec-style referendum is the only way that voters can express themselves unequivocably (depending on the wording) on issues of federal-provincial relations. Is a government going to forgo obtaining political credit or shifting political blame through federal-provincial manoeuvring at the relevant margins on the grounds that the electorate is bored or impatient with the battle? To put the point the other way: parliamentary task forces are most likely to be used when they are thought to be effective in securing credit, in shifting blame, in showing concern, or in delaying action. They are most unlikely to change the *objectives* of obtaining credit or shifting blame, however. Dare one say that if governments can accomplish these objectives by encouraging misleading perceptions, the political call for a better-informed electorate will be largely rhetorical? And given the economic realities of the mass media, are journalists likely to translate more information into more public understanding?

CONCLUSIONS

Let me try to end on a more positive note. There seems little doubt that in 1987 the spectre of slow growth, with concomitant demands for fiscal restraint and provincial protection, is likely to exacerbate the tensions that invariably surround federal-provincial fiscal negotiations. There are also good odds that the federal arguments for increased fiscal restraint will, to a considerable extent, be based on an erroneous but strongly held public perception that the federal deficit is more structural than it is. (In reality, the problem should prove largely self-correcting, although at a distressingly slow rate – a rate that will be further slowed by ill-considered attempts to reduce the deficit by raising taxes or cutting expenditures, federally or provincially.) There is also a distinct possibility that, faced with continuing economic malaise, voters will look to the federal government, rather than the provinces, for leadership, as they have in past periods of crisis. There is a danger that the federal government will abuse this trust by failing to put its own house in order (for example, by not reducing the kind of distorting policies now present in some features of Unemployment Insurance) and by insisting upon changes in existing federal-provincial programs that would make them even more rigid, more distorting of resource allocation, and less amenable to efficiency improvements than they are now. The recent changes in the Canada Health Act were, to say the least, unfortunate in this regard, and there are ominous signs that the federal government is about to turn its attention to postsecondary education (the widely accepted myth that we now know how to match training and job opportunities – an exercise once called manpower planning before it was largely discredited – will no doubt be used as the rationale). One cannot help but look upon increased federal intervention with extreme trepidation.

There is also a legitimate fear that the provinces will increase their protectionist measures, further weakening the economic union, and that the federal government will be unable or unwilling to resist them.

Are there rays of light in this gloomy prospect? There are some *potential* glimmers:

– After the November 1984 U.S. presidential election, there is some hope that the Americans will tackle their deficit problem seriously

and with finesse so that interest rates in other countries, including Canada, will decline. Such a move would do wonders for restoring a more vigorous rate of expansion here and abroad. The Canadian fiscal deficit would decline more rapidly, and the popular demand for greater fiscal stringency would be muted. Among the results would be reduced support for federal intransigence in the 1987 negotiations.

– There is a general feeling that the political balance of the country has shifted to the right, favouring less government intervention. Conceivably, this shift may dampen federal enthusiasm for such measures as reconverting the postsecondary-education program to a conditional-grant program.

– There seems to be increased public awareness of the costs of protectionism in its multitudinous guises. A quickened pace of growth (largely resulting from U.S. policy success) would make it easier for the provinces to maintain their virtue in the face of continuing blandishments from special-interest groups.

– The new constitutional basis for federal-provincial equalization payments gives the provinces a new *legal* right *vis-à-vis* the federal government that may enhance their bargaining power.

As I have emphasized, many, though certainly not all, of the problems of federal-provincial fiscal relations are perceptual in nature. Voters' erroneous perceptions or misconceptions are a significant factor. Although perceptual difficulties are as politically important as 'real' difficulties, the former are certainly more amenable to amelioration through public discussion. Conferences such as this, particularly if the papers and proceedings are not only published but 'translated' into language that the mass media can communicate to the voters at large, can make a positive difference.

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The politics of positive sum

Michael J. Trebilcock

In reviewing the prospects for federal-provincial fiscal relations during the 1980s, it seems useful to separate the issues into those of substance and those of process: how will the agenda of substantive issues in federal-provincial fiscal relations evolve over the 1980s? how adequate are the existing consultative and decision-making arrangements likely to prove in addressing this agenda?

THE NATURE OF THE EMERGING AGENDA

As Al Johnson told this conference, the subjects for debate in federal-provincial fiscal relations never seem to change. In retrospect, there are three constants: equalization of the fiscal capacity of the provincial governments, tax-sharing between the national and provincial governments, and shared-cost programs. The permutations of aspects of these issues have, of course, changed significantly since the early 1960s (see Veilleux 1980, 33), as has the economic environment in which they have been debated.

The overriding characteristic of these policies is their redistributive nature – specifically, their regionally redistributive nature. This is obviously true of the equalization program, but, as Keith Banting pointed out to us yesterday, it is also true of many income-security programs, whose regionally redistributive impacts may be greater than those of the equalization program. The same emphasis appears in many policies outside the specific framework of the fiscal arrangements; for example, regional redistribution is clearly impor-

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tant in policies on energy pricing and the distribution of energy rents.

The central premise of my comments is that the present federal-provincial fiscal arrangements ignore and to a significant extent undermine economic efficiency, both in a broad allocative sense relevant to national economic performance and in a narrow, instrumental sense in the social-policy sphere. Experimentation, innovation, dynamism, cost effectiveness, and adaptation are critical values in both economic and social policymaking. Achieving them on the economic front requires that the federal government use its taxing and spending powers to enlarge its influence on the economic policies of provincial governments, even in areas of exclusive provincial jurisdiction. In the social-policy sphere, however, efficiency considerations appear to demand a reduced federal role in the shaping of provincial policies and correspondingly more room for provincial experimentation and innovation.

That present federal-provincial fiscal arrangements come close to inverting the roles efficiency considerations imply for the federal government in these two spheres suggests an opportunity for a welfare-enhancing 'trade'. To show how such a swap might work, I will comment briefly on federal-provincial fiscal relations in the social-policy sphere and then at greater length in the context of broader issues of national economic performance.

The social-policy sphere

If decision-makers maintain the present thrust of channelling federal funds towards earmarked areas of social expenditures and setting conditions within those areas, one can reasonably predict continuing and perhaps increased rancour and conflict between the federal and provincial governments over the division of the burden of financing shared-cost social programs. As the federal government presses to contain its deficit and limit its financial exposure under these programs, the provinces, which are facing reduced revenues and increased utilization of many of the programs because of the economic environment, do not take kindly to efforts to move more of the fiscal responsibility to them. This resistance is heightened by the provinces' feeling that Ottawa induced them to enter into some of these programs in more buoyant times and that it is now seeking to use federally determined program standards to constrain their efforts at cost-containment.

Health care

What are the prospects for promoting efficiency and innovation in program design and delivery and for reducing intergovernmental conflict in the area of established programs financing? William Watson made a persuasive case at this conference for disentanglement in the health-care field. Provided that the federal government yields tax room or provides cash grants to the provinces to allow them to continue, if they wish, their present levels of resource allocation to the field, efficiency considerations seem to favour allowing them to experiment with alternative delivery systems and rationing modalities. As Greg Stoddart told us, such an approach could reduce costs and enhance technical efficiency in the production of health-care services.

Preserving margins for innovations in as high-cost a budgetary commitment as health care seems imperative. By yielding tax room, the federal government could enhance the fiscal goal of having governments that do the spending also assume the responsibility for generating the revenues. Concerns that greater provincial autonomy might lead to the disintegration of our present health-care system seem unfounded. Given the public support for the system, any but marginal changes would likely entail significant political costs. Moreover, it is not clear why provincial governments should be more vulnerable to pernicious tendencies than the federal government. After all, our present system originated with a provincial initiative in Saskatchewan.

Social security

In the social-security field, marked differences in benefit levels from jurisdiction to jurisdiction may result in inefficient welfare-induced migrations (analogous to the fiscally induced migrations that have resulted from interprovincial differences in energy rents). The need to avoid this inefficiency may justify baseline national standards as an alternative to distorting forms of residence requirements or barriers.

In a similar fashion, the desirability of increasing the portability of pensions and thus enhancing personal mobility may argue for baseline national standards in this area.

Postsecondary education

It is not clear that a substantial federal presence can be economically justified in postsecondary education, any more than in elementary or secondary education, unless one accepts the argument that the development of specialized human capital can be most efficiently rationalized in terms of national labour markets, rather than regional ones. This consideration seems most relevant to advanced postgraduate study, high-level research, and adult training and retraining; as David Slater told the conference, extrajurisdictional spillovers from research or adjustment may justify a federal role in these cases. However, the federal government is already directly involved in all these areas (for example, through the National Research Council, the Canada Council, the Social Sciences and Humanities Research Council, and the National Training Act). Whether that involvement is large enough or well directed enough may be relevant issues, but there seems little justification for extending federal involvement into other areas of education policy.[1]

Tax-sharing, equalization, and the financing of programs

One of the strengths of a federal system is its fostering of diversity within broad national parameters. In the area of social and educational programs, given the limited and relatively readily identifiable negative spillovers from one jurisdiction to another, the need to encourage experimentation, innovation, and dynamism in program design and delivery suggests a strong bias towards provincial autonomy. Concerns about the fiscal capacity of some provinces to provide adequate services may exist, but this distributive objective can be adequately met through appropriate arrangements for tax-sharing (for vertical fiscal balance) and equalization (for horizontal fiscal balance) with minimum constraints on the allocation of resources among programs or on the requirements within them. In other words, in considering the country's redistributive objectives, we may need to re-evaluate the relationship among tax-sharing, the equalization program, and established programs financing (EPF).

National economic performance

The preoccupation with social-program financing and regional equalization that has characterized federal-provincial fiscal relations

to date may be subject to a much more significant convulsion in the future. Clearly, this concentration only peripherally admits issues of national economic performance. Yet as Veilleux (1980) suggests, the focus in federal-provincial relations is almost certain to shift towards issues relating to the structure and long-term development of the economy: energy supply and pricing, the control and development of industry, nontariff barriers to interprovincial trade and the domestic mobility of capital and labour, international trade and tariff policy, and the regulation of financial institutions. Noting that Canada's machinery for dealing with intergovernmental issues has not been used extensively for problems of this kind, Veilleux suggests that the new issues will be even more troublesome than those we have faced in the past.

Veilleux's pessimistic view, that intergovernmental agreements will be difficult to reach on these issues, contrasts with the more optimistic forecast of diminished intergovernmental tensions that Richard Simeon gave the conference. Jenkin (1983), however, shares Veilleux's view of the agenda of economic issues confronting both levels of government and of the inadequacy of current intergovernmental structures to deal with them. He describes the tasks facing policymakers:

> The Canadian economy faces a very trying and uncertain future. The issues we must confront in the coming decade go far beyond the daunting problems of the current recession with its high rates of unemployment and low economic growth. Over the next decade, the challenge for Canadians will be to transform the economy structurally in order to compete effectively in what can only be called a radically altered, world-trade environment. There is no alternative to significant structural change. . . .
>
> At the very time when Canada needs effective leadership on national economic policy questions, our governments seem to be moving in opposite directions. At the federal level, leadership had been lacking for a variety of complex reasons . . . not the least of which has been the difficulty of implementing industrial policies in an economy that is highly differentiated from region to region, and where political consciousness of those regional differences is growing. At the same time, in large measure in response to the vacuum created by weak federal leadership, the provinces have

> become more aggressive and expert at promoting the industrial expansion of their own economies. The result has been a form of paralysis, an inability to forge a national effort to restructure industry at a crucial time in the country's economic development. (1983, 169-70)

Thorburn echoes many of the same concerns in his statement of the Canadian predicament:

> At the same time as these external changes were occurring, Canada proceeded to weaken its competitiveness by its own actions. Quebec nationalism and a growing awareness of regional economic inequalities led Canadian governments to perceive Canada's primary problem as one of internal dissent, which had to be appeased by programs of equalization of services between regions and by the institution of costly programs of bilingualism and equality of opportunity for minorities.
>
> Moral and laudable as such programs were, and in many cases necessary to preserve the nation, they had the effect of diminishing the competitiveness of the Canadian economy. Many nonviable enterprises in disadvantaged regions were begun or were shored up at the taxpayers' expense. Generous social security programs were put in place that encouraged people to remain in uneconomic jobs and in disadvantaged parts of the country. The Canadian economy became an increasingly high-cost one compared to the international competition. (1984, xiii – xiv)

What is striking about the issues that have dominated federal-provincial fiscal relations to date is that, with the major exception of energy policy, they have enabled the provincial governments to make common cause against the federal government. But with increasing disenchantment with the ability of macroeconomic policies, Keynesian or monetarist, to foster stable rates of economic growth, the focus is now increasingly on microeconomic (industrial or structural) issues. Here, there is much less reason to assume common cause amongst provinces with their diverse economies. Although both federal and provincial governments provide substantial industrial assistance (see Trebilcock et al., forthcoming, chap. 2), co-ordination between levels of government is so weak that Bliss (1982)

calls the situation 'blooming, buzzing confusion'. In many cases, these programs cancel each other out. For example, some provide countervailing locational incentives (see Flatters and Lipsey 1983). Some involve internal trade distortions, and, coupled with social programs, such as unemployment insurance and equalization payments, they entrench, as Thorburn (1984) and Courchene (1983) suggest, serious misallocations of resources. National tariff barriers have already created industrial structures that involve a high percentage of branch plants, small production runs, too many product lines produced primarily for the domestic market, and too little investment in research and development; the danger is that interprovincial trade barriers will exacerbate this tendency by fragmenting even the domestic market. Important recent work by Harris and Cox (1984) underscores the size and seriousness of present and potential losses to the Canadian economy caused by external and internal protectionism.

The need for industrial adjustment

In examining the economic performance of other major industrialized countries over the past several decades, analysts now generally agree that those that have performed most strongly (West Germany and Japan) are those that have adapted most quickly to change, be it technological, energy-related, or reflective of shifts in international comparative advantages. What also seems clear is that these countries have institutional characteristics that facilitate the concentration or integration of policies fostering rapid adjustment and addressing the distribution and mitigation of the costs of transition. Particularly significant factors seem to be the influence of financial institutions, of 'peak' or encompassing interest groups (particularly business and labour), and of a strong central government with well-integrated regional perspectives (see, for example, Reich [1983]; Olsen [1982]; Zysman and Tyson [1983]; Katzenstein [1978]; Magaziner and Reich [1983]; and Adams and Klein [1983]).

In Canada, policies to facilitate rapid industrial adjustment are juxtaposed, often in extreme tension, with policies that promote regional fiscal equalization or, even more seriously, with those that encourage regional equalization in production (see Courchene 1983). Moreover, institutional configurations in both the public and the

private sectors tend to be highly fragmented and do not readily lend themselves to the rapid development and evolution of widely accepted strategies for economic adjustment (see Jenkin [1983]; Thorburn [1984]; Hartle [1980]).

As the Macdonald Commission put the overriding question in *Challenges and Choices*: 'How can we better manage and adjust to change? If there is a single, major concern among Canadians, it relates to that question' (Royal Commission on the Economic Union and Development Prospects for Canada 1984, 27).

Given the need to improve our adjustment to change, the intergovernment economic agenda seems to include at least four classes of urgent issues:

1 How can we better protect the internal common market? Should we not be seeking concerted federal and provincial action in areas such as government procurement policies, industrial subsidies and tax policy, pension portability and transferability of educational and training credentials, public ownership (tax and subsidy issues), and regulatory policies that impede interprovincial trade (for example, marketing boards)?

2 How should we structure our international trading relationships, in particular with the United States but also with the less-developed countries? Should we vigorously pursue bilateral free trade (sectoral or otherwise) or even more ambitious forms of multilateral free trade? (See Harris and Cox 1984.)

3 Given declining tariff levels and marked shifts in international comparative advantages, how do we best deal with problems of negative adjustment – the withdrawal of resources from declining sectors, such as textiles, leather, shoes, shipbuilding, and coal mining? As Lester Thurow remarks:

> Disinvestment is what our economy does worst. Instead of adopting public policies to speed up the process of disinvestment, we act to slow it down with protection and subsidies for the inefficient. If our steel industry cannot compete, we protect it. If our television industry lags behind, we negotiate 'orderly' marketing arrangements to keep out foreign-made sets. If textiles are a low-productivity industry that should be located abroad, we adopt stiff tariffs to preserve a local industry. Our shipbuilding industry is an

industry completely dependent upon subsidies. All of these actions are designed to provide economic security for someone, yet each of them imprisons us in a low productivity area. If we cannot learn to disinvest, we cannot compete in the modern growth race. (1980, 77)

4 What role should each level of government play in facilitating positive adjustment – the redirection of resources into the sunrise sectors (for example, subsidies to research and development), education, technical training, retraining, and infrastructure development?[2] Clearly, the difficulties of promoting adjustment are more severe in bad times than in good, given the scarcity of alternative opportunities, but West Germany, Japan, and, to a lesser extent, France have not been deterred by these difficulties.[3]

Adjustment and fiscal arrangements

To date, many Canadian policies, including those we have historically treated in the context of fiscal arrangements, have been designed to deflect adjustment, rather than facilitate it. Can we any longer afford this luxury? If not, the intergovernmental agenda must change radically to reflect this reality.

For example, can we any longer justify totally unconditional equalization payments that have no orientation adjustment – the intrasectoral, intersectoral, intraregional, and, most importantly, interregional reallocation of resources and people – that is designed to reduce their scale? Surely there are limits to the price we are willing to pay for the 'stay' option. Can we justify social programs such as the present incarnation of Unemployment Insurance, which has regionally and, in some cases, sectorally differentiated benefits with no adjustment conditions attached (for example, retraining, wage vouchers, or subsidies)? Given the impact of falling tariff levels and shifts in comparative advantage on the industrial heartland of Canada, should the federal government underwrite some of the costs of negative and positive adjustment in order to facilitate these changes? Should it underwrite some of these costs for provinces that suffer as a result of the withdrawal of internal barriers to trade? In other words, should the federal government shift its emphasis in federal-provincial fiscal relations away from bribing provinces to accept social programs and from intermediating untied fiscal transfers towards bribing provinces (or interests therein) to accept

the costs of change? If so, where can the requisite resources be found in a time of economic and fiscal austerity?

INSTITUTIONAL CAPACITY

Simeon (1980, 31-2) rightly observes that we cannot entertain unrealistic expectations about the tasks we ask the present intergovernmental apparatus to perform. It has registered significant successes in the past (see Veilleux 1980), but the 1982 negotiations of fiscal arrangements showed that when the economic environment becomes more austere, the room for consensus becomes much more constrained (see Perry 1983; 30). Moreover, as Simeon (1980, 31-2) also notes, the present mechanisms emphasize territorial politics or vertical interests; horizontal divisions of interests – capital, labour, and consumer; rich and poor – are very weakly integrated into the process.

These concerns have led to various suggestions for expanding and integrating other inputs into the process, including: parliamentary task forces (the role of the 1981 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements is widely thought to have been constructive [see Simeon 1982, 41]); a permanently constituted council of industry and technology ministers and a reconceived Department of Industry, Trade and Commerce with a substantial capacity for policy development (Jenkin 1983); a federal-provincial development commission, also with considerable forward-planning capabilities (Thorburn 1984); the upper house of Parliament reconstituted as a house of the provinces; reform of the electoral rules to enhance the breadth of support for the major federal political parties; and constitutional reform to constrain provincial and federal governments from creating internal barriers to trade (see generally, Trebilcock et al. 1983). Obviously, many of the proposals have little prospect of early implementation. In any event, all would require careful evaluation of their likely effectiveness.

A code of economic conduct

A more modest proposal for the medium term is to use contractual codes of conduct to attack impediments to the operation of the internal common market. What I have in mind are instruments whereby both the federal and provincial governments would agree

to the regulation of various barriers to domestic trade (procurement policies, tax policies, industrial subsidies, lack of pension or credential portability, and so on) that are significantly at variance with national economic interests.

The incentive for the provinces to agree to such codes would be the federal government's requirement of endorsement as a condition of receiving fiscal transfers under shared-cost programs or the equalization scheme. The *quid pro quo* for this increase of centralization in the economic sphere would, of course, be increased provincial autonomy in the social-policy sphere, achieved by Ottawa's withdrawal of most conditions pertaining to program standards.

To make such a scheme effective, the initiative should be announced, in a strong federal statement, early in the life of the present fiscal arrangements, and the federal government's own commitment to the codes should be enshrined in the next round of fiscal-arrangements legislation.[4] The actual negotiation of the codes could be assigned to a representative federal-provincial commission, which thereafter could function rather like the Commission of the European Economic Community, fleshing out the agreements by issuing appropriate directives to governments, monitoring adherence, hearing complaints of violations from the governmental signatories and from private citizens, and recommending compliance or enforcement actions to the federal or provincial governments.

Clearly, these codes would be incomplete in their coverage and would contain exceptions and qualifications, reflecting strongly desired regional policies, as do the comparable constraints of the General Agreement on Tariffs and Trade and those of the European Economic Community. But by spotlighting the issues of internal free trade, by providing a structured, representative, and visible forum for debate and resolution of complaints, and by being backed by the threat of fiscal penalties by the federal government, they would make a start on reintegrating our domestic markets.

Initially, the codes could be of the same duration as the fiscal arrangements so as to avoid long-term commitments with uncertain impacts.[5] Eventually, however, one might contemplate their enshrinement in federal legislation, directed to *both* levels of government as an exercise – and test – of the federal government's trade and commerce power, that would create legally binding and privately enforceable prohibitions.[6]

General adjustment agreements

Another, probably much more pressing economic issue is how to deal squarely with the need for and costs of rapid economic adjustment. This is probably the nation's central economic problem, and it seems critically important that the federal government play a major role in confronting it.

One possibility here is to re-evaluate the general development agreements, which are mostly bilateral and cost-shared, and resuscitate them in the form of what might be more appropriately called general adjustment agreements. Financing could come from redirecting to these programs significant proportions of the present federal and provincial industrial assistance plus part of the federal funds spent on manpower training; more radically, the governments could subtract a significant portion of the aggregate projected costs of the agreements from the equalization formula.

Areas in which government can play a significant role, if comparative experience is relevant, include the reorientation of training programs, retraining, severance payments, early-retirement schemes, wage vouchers, relocation allowances, compensation for scrapping physical capacity, specialization agreements, and induced firm mergers and rationalizations. The central importance of and potential gains from intrasectoral adjustments to promote optimal economies of scale and specialization in existing industries (see Harris and Cox 1984) suggest that facilitating such adjustments, especially in the manufacturing sectors, might be a major focus of general adjustment agreements.[7]

Given the mostly bilateral and transitional nature of such agreements, using them as the nation's principal adjustment mechanism would minimize the costs and complexities of intergovernmental interactions while allowing the federal government to exert a mediating influence on the more destructive and wasteful forms of interjurisdictional competition by directing resources so as to maximize regional specialization. Unlike previous general development agreements, which focused mostly on the poorer regions, the new agreements could – and probably should – be directed to a significant extent to Ontario and Quebec. These two regions probably face the most wrenching adjustment problems in their manufacturing sectors in the face of declining tariff levels and marked shifts in comparative advantages, difficulties that may

become more acute in the short run if national policy pursues freer trade with the United States.

The rationalization of adjustment aid

Whatever mechanisms are used, the need for a rational approach to adjustment is great. We have recently observed federal and provincial governments playing an adjustment role in the restructuring of the Atlantic fisheries, although insufficient attention to crafting imaginative distributional strategies for easing the costs of change may have led to the perpetuation of some inefficient local processing plants. However, we have also observed independent federal and provincial assistance being provided to three failing companies in the farm-machinery industry, which has serious excess capacity. An excellent opportunity for rationalization was lost. Similarly, the federal government did not pursue opportunities to induce Maislin Trucking Ltd. to merge with other Canadian-owned long-haul carriers; the company ultimately failed, at a cost to federal taxpayers of $35 million. (See Trebilcock et al., forthcoming.)

We must facilitate the process of adjustment by socializing some of its costs. The trade-off is not so much between equity and efficiency as between stability and dynamism, and public policy has a major role to play in easing the costs of transition so that they do not translate into political vetoes on change. (See Thurow 1980; Courchene 1980, 556.) Innovation, dynamism, and adjustment seem to be the economic bywords of the future but they must be reconciled with distributional and political concerns about the impacts of change.

In the long term, developing a more concerted and integrated view on the need for change, its directions, and the distribution of its transitional costs will almost certainly require reorientation of many of our fragmented institutional mechanisms in both public and private sectors. Today they too often work from restricted, short-term, self-interested perspectives so that the costs of proposed policies are not fully internalized by their proponents and 'prisoners'-dilemma' problems abound (see Flatters and Lipsey 1983). The reorientation process may need to start at the plant level with more extensive management-worker consultation, move up to more open, broader, and more systematic consultative processes among governments and widely representative business and labour interests, and finally yield more integrated regional and national perspectives

in our central institutions. For the last step, Senate reform, electoral reform, and greater use of parliamentary task forces and federal-provincial commissions are all potentially fruitful mechanisms.

CONCLUSION

Clearly, the essentially territorial redistributive politics of past federal-provincial fiscal relations can no longer be expected to bear the full burden of collaborative decision-making in the face of the daunting economic challenges that now confront this nation. Thus, both the agenda and the processes of fiscal decision-making in Canada require radical reconception. In particular, the notion that distributional issues and economic issues can be bifurcated, as in present intergovernmental fiscal relations, ignores the critical importance of further integrating the two if the politics of change are to be effectively managed. Focusing primarily on distributional issues exacerbates the politics of zero sum, which are nasty, brutish, and self destructive. Focusing primarily on economic issues ignores legitimate public concerns about the incidence of the costs of transition and generates political vetoes on change. Only a major and conscious effort at integrating and reconciling economic and distributional objectives in our policymaking processes can give us any hope of overcoming the paralyzing politics of zero sum (see Thurow 1980). Although the politics of positive sum are complex and challenging in an austere and uncertain economic environment, they are ultimately likely to prove infinitely more rewarding than a Hobbesian war of all against all or even Buchanan's more benign 'random walk in socio-political space' (1975, 67).

NOTES

1 An exception may be the facilitating of arrangements for ensuring reasonable portability of credentials. This issue may provide a justification for conditionalizing grants, in the manner generally proposed later, but only if the focus is narrowly on increasing the interjurisdictional recognition of technical, educational, and professional credentials and thus promoting greater mobility of human capital.
2 This question is particularly tricky given the hazards of governments' attempting to pick winners as opposed to fostering the general conditions that encourage the rapid evolution of winners.
3 In marked contrast to Great Britain.
4 Federal commitment would be important not only as an inducement to provincial endorsement but also in itself; recent analysis suggests that federal policies have

tended to distort internal trade flows substantially more than provincial policies have (see Trebilcock et al. 1983).

5 In this and other respects, the proposal of codes is superior to the proposal of amending Section 121 of the Constitution; the latter action would have the dual political vices of being semipermanent and of throwing a largely undefined prohibition to nonexpert and unaccountable courts for elaboration (see Dupré 1980, 54).

6 See the recent discussion of the trade and commerce power by Dickson, J. (now C.J.) in *A.G. for Canada v. Canadian National* (October 1983), suggesting a possible reconsideration of the scope of the trade and commerce power in matters of federal economic policymaking.

7 In contrast to the present general development agreements, which have often tended to promote new industries – to 'pick winners' – despite the acknowledged hazards of government's trying such a role.

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APPENDIX
BACKGROUND PAPERS

Federal-provincial fiscal relations: some background

Kevin Dowd and Adil Sayeed

This paper provides two kinds of background information on federal-provincial relations. The first section gives a brief summary of the main historical developments in Canadian federalism from Confederation to the proclamation of the new Constitution in 1982. The second presents a statistical overview of federal-provincial fiscal arrangements and related matters.

A BRIEF HISTORY OF FEDERAL-PROVINCIAL FISCAL RELATIONS

A thorough survey of the important developments in federal-provincial relations cannot be presented in a short background paper. The following summary is intended as an introduction to the subject. Readers interested in more detailed accounts should consult Bastien (1981), Courchene (1979; 1984), and Moore, Perry, and Beach (1966).

1867-1940

The history of Canadian federalism begins with the Constitution Act of 1867 (formerly known as the British North America Act). This act granted the federal government access to all tax fields and exclusive access to indirect taxes, including customs duties, which at the time were the largest single source of government revenue. The federal government compensated the provinces for the loss of this revenue

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source by statutory subsidies: $0.80 per inhabitant up to a maximum population of 400,000. The cap meant that Nova Scotia and New Brunswick, whose governments had been almost entirely dependent on customs duties, received larger payments per capita than did Ontario and Quebec. In the first years following Confederation, the two Maritime provinces depended on federal transfers for more than 80 per cent of their revenues, while the governments of Ontario and Quebec had other revenues about equal to their grants from the federal government. Thus, it is possible to trace back to Confederation some notion of 'equalization' – of the federal government's providing more generous payments to some provinces than others so as to 'equalize' the revenue bases of all provinces. As all the provinces developed new revenue sources of their own (see Table 1), the relative importance of federal transfers slowly diminished. By 1930, federal grants were less than 10 per cent of total provincial revenues.

The Great Depression brought on a major crisis in federal-provincial fiscal relations. During the 1920s, many provinces had borrowed heavily to finance the construction of road networks and hydroelectric facilities. These capital projects were expected to lay the basis for future economic growth, thereby generating enough revenue to pay for their own financing. The expected revenues vanished with the onset of depression, which also increased demands for spending on social welfare, then a matter of exclusively provincial jurisdiction. Thus, the provinces faced heavy debt-repayments and outcries for more social measures just as their revenues were shrinking.

They responded to the fiscal crisis by searching for new revenue sources. In 1930, only three provinces had a personal income tax, and only two taxed corporate income. By the end of the decade, all nine taxed corporate income, and all but two had adopted a personal income tax.

Dissatisfaction developed quickly with this state of affairs. Individuals and corporations had to fill out two tax forms, one federal and one provincial. Tax rates and definitions of taxable income differed from province to province. Many people feared that this 'tax jungle' would hinder a revival of economic activity. In addition, although federal transfers increased to a third of total provincial revenues during the decade, the 'ad hoc' process of readjusting them

TABLE 1
Federal-provincial fiscal relations: a selective chronology, 1867-1940

Year	Event
1867	Constitution Act contains provisions for federal payment of statutory subsidies to compensate provinces for giving up the right to levy indirect taxes.
1876	B.C. is first province to levy personal income tax (PIT).
1882	Quebec is first province to tax corporations.
1906	First federal-provincial fiscal relations conference. Federal government agrees to increase statutory subsidies.
1917	Federal government introduces its own PIT.
1922	Federal PIT ruled constitutionally valid.
1926	Federal government adopts Duncan Commission recommendations for special grants to the three Maritime provinces.
1930	Jurisdiction over natural resources ceded to Prairie provinces.
1932-9	Provinces seek new revenue sources.
1940	Rowell-Sirois Report recommends sweeping changes in federal-provincial fiscal relations.

was straining relations between the two levels of government rather than encouraging a co-ordinated search for solutions to the nation's economic ills.

These problems led the federal government in 1937 to appoint the Royal Commission on Dominion-Provincial Relations to look into the state of federal-provincial relations. Three years later, in 1940, the commission submitted its report, commonly known as the Rowell-Sirois Report. It made a number of major recommendations, which can be summarized under three main headings:

1 *Revenue-raising powers.* The provincial governments should give up the power to tax personal and corporate incomes. In return, the federal government should assume responsibility for paying off previously incurred provincial debts.

2 *Spending responsibilities.* The federal government should assume exclusive responsibility for unemployment relief and old-age pensions.

3 *Equalization.* Federal statutory subsidies should be replaced by a system of 'national-adjustment grants' that would be more generous to the poorer provinces.

Federal-provincial negotiations over these recommendations broke down, and none was immediately implemented exactly as specified in the report.

Post-1940 developments

Although the Rowell-Sirois proposals were not adopted wholesale, they did have a lasting impact on the course of federal-provincial fiscal relations. In fact, a summary of federal-provincial developments since 1940 highlights the influence of the report (see also Tables 2 to 4).

Revenue-raising powers

Although the provinces refused to give up their constitutional right to tax income, they did agree to cede full power to the federal government for the duration of the Second World War. The federal government agreed to make special cash payments to compensate the provincial governments for temporarily withdrawing from income taxation.

After the war, all the provinces except Ontario and Quebec agreed to continue this 'tax-rental' arrangement. While neither holdout immediately established a personal income tax, both resumed collection of corporate taxes and succession duties.

The other provinces did not re-enter the income-tax field until 1962, when the existing federal-provincial tax-collection agreements took effect. Under them, the provinces are free to tax income and to set their own rates for doing so. Each has the option of setting up its own collection system or of allowing the federal government to collect revenues on its behalf. The advantage of using the federal collection system is that administrative and filing costs are minimized since taxpayers face a single tax form. The disadvantage is that the

TABLE 2
Changes in revenue-raising powers: a selective chronology, 1940-84

Year	Event
1940	Rowell-Sirois Report recommends federal takeover of income-tax field.
1941	Wartime tax agreements signed (in force 1942-7). Provinces give up income taxation in return for 'rental' payments.
1947	Most provinces approve 5-year extension of 'tax rental' agreements with modified formula for setting federal payments. Ontario and Quebec refuse to sign agreement and resume their own corporate income taxes (CITs).
1952	Most provinces approve a further 5-year extension of 'tax rental' agreements with another change in payment formula. Ontario signs agreement and drops CIT. Quebec does not sign.
1954	Quebec establishes its own PIT.
1957	Tax-sharing agreements signed (in force 1957-62). Federal 'rental' payments transformed into percentage shares of income taxes collected in each province; equalization payments make up differences in provincial shares. Quebec does not sign. Ontario opts out partially and collects its own CIT.
1962	First tax-collection agreements signed. Each province can set its own tax rate as a percentage of federal tax collected within its boundaries and have the federal government collect the revenues. Basic form of agreement continues to hold today. Quebec does not sign. Ontario continues to collect its own CIT.
1972	Federal tax reform changes definition of taxable income. Federal government agrees to make revenue-guarantee (RG) payments to compensate provinces for revenue losses resulting from tax reform.
1975	RG payments extended for 2 more years.
1981	Alberta establishes its own CIT.

province must accept the federal definition of taxable income and tax brackets.

Quebec is not a signatory to the tax-collection agreements and collects its own corporate and personal income taxes. Ontario and Alberta collect their own corporate income taxes but permit the federal government to collect personal income taxes on their behalf.

To summarize, the income-tax system of today bears the stamp of the Rowell-Sirois Report, even if its proposal of giving the federal government full power over income taxation has not been imple-

mented. Although the provinces set their own tax rates, most allow the federal government to establish the definition of taxable income. Use of this common definition means Canada's provincial tax systems have a greater degree of harmony than existed in the 1930s.

Recently, however, the provinces have seemed increasingly dissatisfied with settling for the federal definition of taxable income. Alberta began to collect its own corporate tax in 1981, and both Ontario and British Columbia have publicly stated that they were seriously considering the option of setting up their own collection systems for personal income taxes.

Spending responsibilities

A constitutional amendment in 1941 implemented the Rowell-Sirois Report's recommendation that the federal government assume full responsibility for unemployment relief. A further constitutional amendment ten years later transferred primary responsibility for old-age pensions to the federal government.

These changes had a particularly broad impact in that they legitimized the notion of federal participation in social programs, which had previously been considered matters of purely provincial jurisdiction. The following years saw a move towards federal cost-sharing of provincial social programs; new transfer programs were initiated to compensate the provinces for part of their spending in areas such as health care, postsecondary education, social welfare, and vocational retraining.

In part, the rise of cost-sharing in the postwar period can be attributed to an imbalance between responsibilities for expenditures and powers to tax. The provinces were responsible for social programs but had 'rented' their power to tax income to the federal government. Rather than shift that power back to enable the provinces to finance their own programs, the federal government agreed to make cash transfers covering a portion of provincial social spending.

In 1965, the federal government started to take a different tack. It gave the provinces the option of 'contracting out' of cost-sharing arrangements in favour of a reduction in federal tax rates that would make room for an equivalent rise in provincial rates. Only Quebec took advantage of this offer of a greater role in setting up its own programs. Nevertheless, the contracting-out provisions were signifi-

TABLE 3
Changes in spending responsibilities: a selective chronology, 1940-84

Year	Event
1940	Rowell-Sirois Report recommends federal takeover of unemployment relief and old-age pensions.
1941	Constitutional amendment allows federal government to establish national unemployment-insurance plan.
1945	Conference on Reconstruction held. Federal government proposes national old-age pension and health-insurance plans to be run federally, plus joint, cost-sharing programs in mental health, vocational retraining, and research. Provinces regard these proposals as federal encroachment on provincial responsibilities.
1948	Federal-provincial agreement on cost-sharing of Trans-Canada Highway construction programs. Quebec refuses to accept federal funds for highway construction on grounds that roads are exclusively provincial jurisdiction.
1951	Constitutional amendment gives federal government primary responsibility for old-age pensions, allowing it to establish a national plan. Quebec opts out.
1956	Quebec's Tremblay Report recommends that provinces have sole responsibility for financing social programs.
1958	Cost-sharing of hospital-insurance programs begins. Federal transfers to each province = (25% of per capita hospital expenditures by province + 25% of Canadian average per capita hospital expenditures) × provincial population. Provincial programs must meet minimum 'national standards' to be eligible for cost-sharing.
1965	Established Programs Act adopted. Federal government offers to transfer income-tax 'room' so that provinces can finance hospital insurance and social-welfare programs out of their own tax revenues; if provincial revenues from tax-room shift are less than what provinces would have received by staying in cost-sharing agreements, federal government agrees to make up difference in cash. Only Quebec takes advantage of this contracting-out provision.
1966	Canada Assistance Plan (CAP) introduced, consolidating previously established cost-sharing of social-welfare programs under single program. Federal transfers to each province = 50% of expenditures on social assistance to individuals + 50% of increase in spending on social services above 1964/5 level. Provincial programs must meet minimum 'national standards' to be eligible for cost-sharing. Quebec chooses to contract out of CAP and receive compensation in the form of increased income-tax 'room' from the federal government.
1967	Cost-sharing of postsecondary education (PSE) established. Federal transfers to each province = 50% of provincial spending on eligible PSE programs or $15 per capita (to be escalated each year by growth rate of total national spending on PSE). Newfoundland, P.E.I., and New Brunswick choose per capita grant. Part of federal transfer takes form of shift of income-tax 'room' with balance paid in cash. Provincial programs must meet minimum 'national standards' to be eligible for cost-sharing.

TABLE 3 (continued)

Year	Event
1968	Cost-sharing of medical-care insurance established. Federal transfers to each province = 50% of Canadian average per capita medicare costs × provincial population. Provincial programs must meet minimum 'national standards' to be eligible for cost-sharing.
1972	Federal government imposes a ceiling of 15% on annual growth of PSE transfers.
1975	Federal government imposes a ceiling on growth of medicare transfers.
1976	Federal government imposes another ceiling on growth of medicare transfers.
1977	Federal-Provincial Fiscal Arrangements and Established Programs Financing (EPF) Act adopted. Basis of federal funding of provincial hospital insurance, medicare, and PSE switched from cost-sharing to block funding. Federal transfers to each province = (Canadian average per capita federal transfers for hospital insurance, medicare, and PSE in 1975/6 + value of two equalized income-tax points as compensation for termination of revenue-guarantee payments) × escalation factor based on recent GNP growth × provincial population. Transfer package involves further shift in income-tax 'room' to provinces, with balance made up in direct cash payments. Provinces consider compensation for loss of federal revenue-guarantee (RG) payments to be permanent feature of new agreement.
1978	Federal government proposes revision of formula determining annual increase in EPF transfers. Provinces refuse to consider cutback in federal funding. Federal government withdraws proposal to change CAP transfers from cost-sharing to block-funding basis.
1982	Federal government removes the RG component from the formula for determining EPF transfers to the provinces. Provinces estimate the transfers in 1982/3 are $1 billion less than they would have been with the RG component in the formula. This change affects all provinces.
	Federal government also imposes '6 and 5'% growth ceiling on 32.1% of EPF cash payments (32.1% is the portion the federal government considers PSE component of EPF funds). The provinces estimate this change will reduce total federal payments by roughly $100 million in 1983/4 and $250 million in 1984/5.
1984	Canada Health Act adopted. Federal government imposes penalties on province that permit extra billing and user fees: EPF transfers to a province to be reduced by amounts patients pay in extra billing and user fees.

cant in that they represented the first attempt to move away from cost-sharing.

The established programs financing (EPF) arrangements of 1977 were the culmination of a ten-year search for an acceptable

substitute for direct cost-sharing. After this agreement, provincial spending on postsecondary education and health care no longer determined federal transfers for programs in these areas. Instead, Ottawa and the provinces agreed on a base-year level, with transfers to be escalated each year according to a formula incorporating population and GNP growth rates. In addition, the federal government cut its income-tax rates to give the provinces room to raise their own rates and thereby fund a larger portion of these programs out of their own revenues.

The proponents of this block funding promoted it as in the best interests of both levels of government. The federal government would find fiscal planning easier with a predetermined level of transfers to the provinces. The provinces would benefit from the shift in taxing power and from having greater responsibility for their own social-spending decisions. Many people hoped that these changes would lessen federal-provincial tensions.

These hopes have not been realized. The level of federal EPF funding itself has become the subject of a bitter dispute between the two levels of government. Another source of continuing tension is the federal government's insistence on its right to specify minimum conditions that programs must meet for the provinces to remain eligible for EPF transfers.

Equalization

The system of 'national-adjustment grants' proposed in the Rowell-Sirois Report was designed to enable a province to provide adequate services (at the average Canadian standard) without excessive taxation (on the average Canadian basis). The federal government was to pay these grants to those provinces with revenue bases insufficient to finance 'average' expenditure needs without resorting to 'above-average' tax rates. This proposal was not immediately implemented, although the 'tax-rental' agreements of 1947 to 1956 did embody an element of implicit equalization in that federal payments under them were greater than the amounts some provinces would have obtained by retaining their own income taxes.

The establishment of a formal equalization system in 1957 represented the practical realization of the adjustment-grant proposal. Federal transfers to eligible provinces are determined by a formula designed to assess each province's fiscal capacity relative to a

TABLE 4
Changes in the equalization system: a selective chronology, 1940-84

Year	Event
1940	Rowell-Sirois Report recommends federal government establish 'national-adjustment grants' for provinces unable to provide 'average' services without resorting to 'above-average' tax rates.
1941	At first ministers' conference, Quebec, Ontario, and B.C. reject Report's reform package, including adjustment-grants system.
1947	Some implicit equalization built into 'tax-rental' agreements by allowing some provinces to receive larger amounts from the federal government in 'rent' than they would have obtained if they had taxed income themselves.
1957	Explicit equalization established. Federal payments to each province designed to make up difference between a province's per capita revenues from PIT, CIT, and succession duties and the average per capita revenues of Ontario and B.C., the two wealthiest provinces. Under this formula, all provinces except Ontario receive equalization payments.
1962	50% of provincial revenues from natural resources brought into equalization formula. Equalization standard changed to national per capita average revenues instead of average of two wealthiest provinces. B.C. loses eligibility because of latter change.
1964	Equalization returned to original system. Natural-resource revenues removed from formula; equalization standard back to average over two wealthiest provinces. Additional condition is that province not eligible for equalization payments if 50% of amount by which resource revenues exceed national average of resource revenues is greater than equalization entitlement. Alberta loses eligibility because of this provision.
1967	Formula changed to 'representative national-average standard' (RNAS). Federal payments calculated to close 'fiscal deficiency', which is measured by summing each province's per capita yield in 16 revenue categories and comparing total with national per capita yield averaged across all provinces.
1974	Energy price rises lead to change in formula. 1973/4 energy-revenue levels designated as 'basic' revenues and still subject to full equalization; only one-third of revenues above this level to be subject to equalization.
1977	Equalization formula's revenue categories refined and broken down into 29 potential revenue sources. Treatment of energy revenues changed again: 50% of provincial revenues from nonrenewable resources subject to equalization; ceiling imposed so that no more than one-third of total federal equalization payments can result from resource-revenue equalization.
1981	Further condition attached so that no province with per capita average income above national average in current and past two years can receive equalization

TABLE 4 (continued)

Year	Event
	payments even if eligible according to formula. This condition effectively excludes Ontario.
1982	RNAS changed to 'representative five-province standard' (RFPS). Provincial per capita revenues equalized to average of five provinces – Ontario, Quebec, Manitoba, Saskatchewan, and B.C. Omission of Alberta as one of the representative provinces allows 100% of resource revenues to be brought back into formula. Municipal revenues also brought in. Annual growth of equalization payments limited to GNP growth rate.
	Constitution Act enshrines principle of equalization in new constitution.

specified standard. Since 1957, the equalization formula has undergone a number of important revisions (see Table 4). However, the underlying principle, that the relatively poor provinces should receive federal grants allowing them to provide an average level of services, remains broadly consistent with the philosophy set down in the Rowell-Sirois Report.

The present situation

The preceding discussion brings us up to the current state of federal-provincial fiscal arrangements. Table 5 completes our brief history by presenting a short summary of the main fiscal links that now exist between the two levels of government.

A STATISTICAL OVERVIEW OF THE FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

Having summarized the history and current features of federal-provincial fiscal arrangements, we can now put some flesh on the bones by presenting figures that both illustrate the relative importance of the different links and highlight some of the issues to which they give rise.

Background

To provide some background for our study of the major statistical features of the federal-provincial fiscal arrangements, Table 6 shows

TABLE 5
Federal-provincial fiscal links

Tax harmonization

Income tax collection agreements
Grants in lieu of property taxes
Reciprocal taxation agreements

Intergovernmental transfers

Unconditional grants
    (e.g., fiscal equalization, statutory subsidies)
Conventional conditional and/or shared-cost grants
    (e.g., Canada Assistance Plan)
Established programs financing arrangements
    (cash and tax transfers)
Tax transfer for contracting-out

Other financial links

Payments for goods or services
    (e.g., Canada Manpower Institutional Training Program)
Payments relating to the transfer of land, improvements, or other physical assets
    (e.g., Hospital Transfer Program)
Loans
    (e.g., Canada Pension Plan investment fund)
Joint activities in which each level of government independently finances
    its share of the responsibilities (e.g., Dairy Support Program)
Support of intergovernmental liaison and joint administrative bodies
    (e.g., Federal-Provincial Committee of Officials Responsible for Human Rights)
Miscellaneous
    (e.g., Canada Student Loans Plan)

Fiscal and economic co-ordination

Fiscal co-ordination
    (e.g., annual pre-budget meeting of ministers of finance)
Economic co-ordination
    (e.g., anti-inflation program)

SOURCE: MacEachen (1981, 42)

the changes in provincial per capita incomes from the time of the 1962-7 arrangements to those of 1977-82.

Two phenomena immediately stand out in the table. The first is the very substantial growth in real per capita income in every province. The second is that this growth has not been accompanied by any noticeable reduction in interprovincial disparities. Indeed, by some measures, those disparities have actually increased. Note, for example, that in the Atlantic provinces real per capita incomes grew by about 80 to 90 per cent; the corresponding figures for Saskatch-

TABLE 6
Provincial per capita incomes, 1962-82 (1971 dollars)

	1962-7	1967-72	1972-7	1977-82
Newfoundland	$1,715	$2,246	$2,763	$3,153
P.E.I.	1,663	2,224	2,761	3,025
Nova Scotia	2,146	2,273	3,511	3,741
New Brunswick	2,044	2,580	3,418	3,707
Quebec	3,065	3,674	4,590	5,079
Ontario	4,024	4,857	5,881	6,235
Manitoba	3,043	3,728	4,823	5,168
Saskatchewan	2,500	3,457	5,172	6,090
Alberta	3,629	4,521	6,900	8,690
B.C.	3,747	4,421	5,701	6,488
Canada average	3,399	4,113	5,261	5,863

SOURCE: Estimated from the figures for gross provincial expenditure, population, and CPI in Canada (1983, 130, 120, 174).

ewan and Alberta are, however, considerably more than 100 per cent. The table also shows changes in the relative positions of the provinces. Perhaps the most noticeable is Ontario's fall from first place in 1962-7 to third place in 1977-82. Alberta, on the other hand, has moved up from third place to first, with its per capita income now well above that of any other province.

Table 7 presents more background: government spending in each province as a percentage of GDP. These figures provide an indication of the importance of the role of government in each of the provincial economies and how it has changed over time.

This table reveals a number of interesting features. A comparison of the all-Canada figures for 1964 and 1981 shows considerable growth in government spending relative to GDP, from 25.3 to 38.4 per cent. Notice, however, that this growth has been concentrated in the Atlantic provinces and to some extent, in Manitoba. For example, government spending relative to GDP in P.E.I. climbed from 51.4 to 86.8 per cent during the period, and the other Atlantic provinces experienced similar increases, though they started and ended with slightly lower ratios. The result has been a worsening of the interprovincial disparities that existed in 1964. To give an illustration, in 1964 P.E.I.'s ratio of 51.4 per cent was just more than twice that of

TABLE 7
Government spending relative to the economy (% provincial GDP), selected years

	1964	1972	1981
Newfoundland	34.1	54.8	71.7
P.E.I.	51.4	68.0	86.8
Nova Scotia	46.4	52.1	77.9
New Brunswick	39.5	48.5	64.8
Quebec	23.7	34.4	45.5
Ontario	23.1	30.6	34.2
Manitoba	27.5	35.5	41.3
Saskatchewan	27.0	36.3	32.0
Alberta	23.2	28.4	22.3
B.C.	22.9	28.6	29.0
All Canada	25.3	33.3	38.4

SOURCE: Information from Ontario Ministry of Treasury and Economics, March 1984.

the lowest provinces (Alberta and B.C., with 23.2 and 22.9 per cent respectively); by 1981 P.E.I.'s ratio had grown by more than 35 percentage points, while Alberta's had actually fallen slightly. These comparisons must, however, be treated with care. Alberta's government spending is actually very high: its low government-spending/GDP ratio is only a reflection of its very high income.

A breakdown of government spending by level of government is provided in Table 8. It shows clearly that the governments of the poorer provinces tend to spend considerably more of their GDPs than those of the richer provinces. Thus, provincial government expenditures do not differ as much as provincial GDPs. The implication is that provincial governments try to provide reasonably comparable levels of public service despite the very substantial differences in real per capita incomes. They are enabled to do so by the equalization program, which, in effect, gives them access to a tax base that is closer to the national average than their own.

Table 8 also shows that federal spending is relatively greater in the poorer provinces. This difference reflects the Canada Assistance Plan and regional development programs, which tend to benefit the poorer provinces more than the richer ones.

TABLE 8
Government spending relative to the economy (% PGDP), by level of government, 1981

	Federal spending	Provincial and local spending	Total
Newfoundland	33.4	38.3	71.7
P.E.I.	46.2	40.6	86.8
Nova Scotia	44.7	33.2	77.9
New Brunswick	36.3	28.5	64.8
Quebec	17.4	28.1	45.5
Ontario	16.6	17.6	34.2
Manitoba	18.5	22.8	41.3
Saskatchewan	12.2	19.8	32.0
Alberta	7.1	15.2	22.3
B.C.	11.5	18.4	29.0
All Canada	16.6	21.8	38.4

SOURCE: Information from Ontario Ministry of Treasury and Economics, March 1984.

Federal transfers

The next two tables deal with federal transfers to the provinces. Table 9 presents time-series figures for federal transfers as percentages of gross national expenditures, federal expenditures, and provincial revenues. The figures are presented with and without tax-point transfers because there is some debate as to whether they should be included as federal transfers. Some analysts argue that they should because the net fiscal result would have been the same if the federal government had retained the taxing power and made cash transfers instead. The opposing argument is that such 'transfers' are really revenues raised by the provinces in tax fields to which they have access and must, therefore, be considered as the provinces' own revenues.

A number of trends can be discerned in Table 9. Whether one includes tax-point transfers in federal transfers or not, there is an upward drift till the mid- or late-1970s and then a slow decline. The sudden rise in 1982/3 is something of an outlier, resulting not from an increase in transfers but from the severe effect of the recession in reducing GNP. Similar trends appear when one expresses transfers as proportions of federal expenditures or provincial revenues, with the slight difference that the latter ratio tends to peak in the early 1970s.

TABLE 9
Federal transfers relative to three key variables

Year	Federal cash transfers[a] as percentages of: GNE[b]	Federal expend-itures	Provincial revenues	Cash plus tax transfers[a] as percentages of: GNE[b]	Federal expend-itures[c]	Provincial revenues
1949-52	0.8	5.9	13.4	1.4	9.9	21.2
1952-7	0.5	2.8	7.3	1.7	9.8	27.8
1957-62	1.7	10.2	21.3	2.4	14.6	29.0
1962-7	2.6	17.5	23.3	2.8	19.0	25.4
1967/8	3.0	17.7	24.6	3.9	22.0	31.1
1968/9	3.1	17.9	23.1	4.0	22.0	28.8
1969/70	3.2	18.8	22.5	4.2	23.2	28.3
1970/1	4.0	22.0	24.0	5.1	26.2	29.5
1971/2	4.4	23.0	25.7	5.5	27.0	31.2
1972/3	4.2	21.2	23.5	5.1	24.6	28.4
1973/4	4.1	20.9	22.0	5.0	24.4	27.1
1974/5	4.4	21.0	22.6	5.4	24.6	27.7
1975/6	4.5	20.0	24.1	5.5	23.7	29.5
1976/7	4.7	21.6	23.8	5.7	25.2	28.9
1977/8	4.5	20.4	21.9	6.1	25.8	29.6
1978/9	4.4	20.2	21.2	6.0	25.6	28.5
1979/80[d]	4.2	19.3	21.1	5.7	24.5	28.1
1980/1[d]	4.1	17.7	20.0	5.7	22.9	27.3
1981/2[d]	4.0	16.6		5.5	21.6	
1982/3[d]	4.3	16.5	18.2	6.2	22.1	26.4
1983/4[d]	4.3	16.9		6.0	22.2	

a The column headed 'federal cash transfers' does not include 'tax-rental' payments, which are included in the column headed 'cash plus tax transfers'.
b Transfer totals for each fiscal year divided by GNE for first calendar year appearing in fiscal year (e.g., 1983/4 transfers ÷ 1983 GNE).
c (Cash + tax transfers) ÷ (total federal expenditures + tax transfers). Tax transfers can be treated as expenditures in the sense that the fiscal result would have been the same if federal government had retained taxing power and made equivalent cash transfers.
d Data are estimates.
SOURCES: Transfers taken from Canada (1980); GNE from Canada (1983); federal expenditures from Statistics Canada (cat. no. 68-207, various years); and provincial revenues from Statistics Canada (cat. no. 68-205, various years).

It is interesting to note that in 1982/3 the ratio of federal transfers to federal expenditures had fallen to its lowest value since (at least) the early 1960s (if tax-point transfers are excluded, or its lowest level since 1968/9 if they are included). As a percentage of provincial revenues, federal transfers (however defined) in the same year were at their lowest level since the beginning of the table in 1962-7.

Table 10 gives a breakdown by province and category of federal transfers during the 1977-82 fiscal arrangements. The first category, 'unconditional grants', consists mainly of equalization payments. The second and third categories comprise various transfers to assist the provinces with responsibilities assigned to them under the Constitution: the second category includes transfers for health, medicare, welfare, and regional development; the main component of the third is transfers for postsecondary education. The category 'tax transfers' refers to 'tax room' vacated by the federal government to allow provinces to raise their own tax rates while leaving the overall tax burden unchanged; these figures do not include the tax points transferred to Quebec for opting out of federal programs such as the Canada Assistance Plan, Youth Allowances Program, and EPF. The next two lines show total transfers including and excluding those tax transfers that do not come from opting out. The last category is gross provincial expenditure, which gives an indication of how important the federal transfers are in each of the provincial economies. All figures are given in real (1971) dollars per capita so as to isolate trends from rising prices and population growth.

Table 10 reveals the dependence of the Atlantic provinces on equalization (and to a much lesser extent on regional-development assistance). During the 1977-82 fiscal arrangements, equalization payments made up about one-half of the federal transfers these provinces received. In terms of 1971 dollars, the equalization program gave them about $300 for every provincial resident.

Overall, however, the biggest federal transfer program was not equalization but EPF. Its size can be gauged from the fact that for every resident of Canada the federal government transferred almost $120 under the EPF arrangements; the corresponding figure for the equalization program was about $83. For the richer provinces (that is, those that do not receive equalization payments), EPF constitutes the largest single source of federal funds. For example, of the $251

TABLE 10

The 1977-82 fiscal arrangements: average revenue transfers per capita from the federal government to the provinces (1971 dollars)

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	All provinces[a]
Unconditional grants	$367.8	$366.8	$285.2	$269.2	$148.0	$11.8	$172.7	$33.3	$19.1	$7.2	$83.3
Conditional grants	117.2	144.2	77.8	108.9	87.0	40.0	63.1	90.6	71.0	65.3	66.5
EPF cash payments	130.4	121.2	124.1	123.4	123.1	117.6	124.6	123.8	104.0	107.5	117.6
Tax transfers	42.6	38.3	50.2	46.2	66.2	81.7	59.6	62.0	94.1	87.3	73.9
Total (including tax transfers)	658.0	708.1	537.3	547.7	406.8	251.1	410.2	309.7	265.2	267.3	334.1
Total (excluding tax transfers)	615.4	669.8	487.1	501.5	340.6	169.5	370.3	247.7	171.1	180.0	261.1
Gross provincial expenditures[b]	3.153	3.025	3.741	3.707	5.079	6.235	5.168	6.090	8.690	6.488	

a The difference between total transfers including and excluding 'tax-point' transfers is not equal to the figure given for the tax-point transfer. The discrepancy appears to arise from the primary source, 'Statistical summary' (see below).

b Gross provincial expenditures are estimates of provincial income and are included for the sake of comparison.

SOURCE: Transfers estimated from 'Statistical summary of federal contributions to the provinces 1949-50 to 1981-1982', courtesy of the Department of Finance, Ottawa; price, population, gross provincial expenditures, and total federal expenditures taken or estimated from Canada (1983).

TABLE 11
Indices of provincial governments' real expenditures per capita on health, 1977/8-80/1 (all-Canada average for 1976/7 = 100)

	1977/8	1978/9	1979/80	1980/1
Newfoundland	96.9	99.2	101.9	102.3
P.E.I.	98.4	99.9	98.9	102.6
Nova Scotia	99.4	102.1	104.6	104.0
New Brunswick	100.2	101.3	100.8	98.1
Quebec	99.1	102.3	102.0	99.0
Ontario	98.9	99.2	97.9	95.9
Manitoba	99.6	96.5	96.4	97.0
Saskatchewan	102.5	101.3	106.6	104.7
Alberta	96.7	103.9	109.3	110.8
British Columbia	102.0	108.6	112.1	114.0
All Canada[a]	99.3	101.6	102.2	101.1

NOTES: All figures adjusted by a health-cost deflator.
a Including the Yukon and the Northwest Territories.
SOURCE: Economic Council of Canada (1982, 57).

that Ontario annually received in cash transfers for each resident, EPF made up almost $120.

The table also indicates the importance of tax points. Overall, tax-point transfers are equal to about one-quarter of the total value of federal cash transfers. Since tax points are relatively unimportant for the Atlantic provinces, it follows that they must be relatively more important for some provinces than the nationwide figures would suggest. In fact, the table shows that the ratio of tax-point to cash transfers was almost one-half for Ontario and just over one-half for Alberta. Thus, whether or not one considers tax points to be federal transfers makes a considerable difference in one's estimate of the federal contribution overall and especially for Ontario and Alberta.

Provincial expenditures and tax rates

We turn now to consider expenditures and tax rates among the provinces. Tables 11 and 12 present trends in their spending on health and education during 1977/8 to 1980/1.

First, consider health expenditures. Although disparities exist, they are relatively small, and it is not necessarily the poorer provinces that spend less. For example, in 1980/1 Newfoundland, P.E.I., and Nova Scotia all spent more per capita on health than the national average, and Ontario spent the least. Table 11 also shows a rapid growth in

TABLE 12
Indices of provincial governments' real expenditures per capita on postsecondary education, 1977/8-80/1 (all-Canada average for 1976/7 = 100)

	1977/8	1978/9	1979/80	1980/1
Newfoundland	97.7	103.5	97.7	90.4
P.E.I.	89.9	104.9	105.4	101.7
Nova Scotia	107.5	117.2	113.7	110.7
New Brunswick	100.5	100.6	115.2	109.7
Quebec	103.6	107.8	101.5	98.3
Ontario	100.7	102.6	95.2	88.1
Manitoba	110.6	101.3	100.6	93.9
Saskatchewan	102.9	114.8	106.2	105.6
Alberta	111.4	112.9	109.2	108.8
British Columbia	107.5	114.3	120.2	117.6
All Canada[a]	103.7	106.9	102.1	97.5

NOTE: Calculated on a 'full-time equivalent' basis – i.e., full-time university and college enrolment plus a full-time equivalency of part-time enrolment converted at 3 part-time students to 1 full-time student. Expenditures were adjusted by the GNP price deflator.
a Including the Yukon and the Northwest Territories.
SOURCE: Economic Council of Canada (1982, 57).

health expenditures in Alberta, although in 1980/1 it was British Columbia that spent the most per capita. On the average, however, health expenditures peaked in 1979/80 and declined after that.

Provincial disparities are greater for expenditures on postsecondary education than for health, but again it is not necessarily the poor provinces that spend less. In 1980/81, for example, P.E.I., Nova Scotia, and New Brunswick all spent more than the national average, while Ontario spent about 10 per cent less and was easily at the bottom of the list. On the average, however, postsecondary education did not fare nearly as well as health; expenditures dropped about 9 per cent from their peak of 1978/9 to their 1981 level.

Provincial fiscal capacity

Table 13 deals with provincial disparities in fiscal capacity in per capita expenditure and in tax effort, using data from 1977/8. A number of points stand out. One is the staggering fiscal strength of Alberta in that year. It had a fiscal capacity not far short of *twice*

TABLE 13
Indices of provincial and local fiscal capacity, per capita expenditures, and tax effort, 1977/8

	Fiscal capacity (own-source revenues plus all federal transfers)	Per capita expenditures	Tax effort (actual revenues adjusted for surpluses and deficits)
Alberta	192	118	54
British Columbia	104	100	94
Saskatchewan	98	103	105
P.E.I.	97	96	111
Quebec	92	108	122
Newfoundland	92	88	104
Manitoba	90	99	116
New Brunswick	89	82	97
Ontario	88	94	110
Nova Scotia	88	86	109
All provinces	100	100	100

SOURCE: MacEachen (1981, 48).

that of any other province; it had the highest per capita expenditures in the country, but a tax effort little more than *half* that of any other province. Since 1977/8, Alberta's fiscal capacity must have been massively increased by the Ottawa-Edmonton energy deal and then decreased somewhat by the fall in world oil prices. Its government expenditures have increased very substantially, and its tax effort has probably fallen.

Another point of interest is Ontario's very low relative fiscal capacity. Along with Nova Scotia's, it comes at the bottom of the table, probably because of Ontario's ineligibility for the equalization payments that some of the other provinces receive.

The provinces with the greatest tax efforts are Quebec and Manitoba. Most of the Atlantic provinces have a relatively low fiscal capacity (P.E.I. is the exception), and their tax efforts are not particularly high (indeed, New Brunswick's is quite low).

CONCLUSION

A short paper like this is not able to cover in any depth any of the issues involved in federal-provincial fiscal relations, but perhaps it does give some illustrations of their complexity. It also suggests what

the main issues are, what they mean for the federal government and the various provinces, and what they mean for Canadian federalism in general.

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The Canada Assistance Plan: some background

Adil Sayeed

The purpose of this paper is to serve as a source of basic information on the Canada Assistance Plan (CAP). The first section sets out the key features of the CAP legislation. The second section presents some figures on the disbursement of CAP funds by province. The third section outlines alternatives to the existing CAP arrangements. The fourth section discusses how the CAP fits in with other income-security programs. In general, the primary focus is on general social assistance because data on these programs are more readily available and comparable than information on other CAP programs.

THE CAP LEGISLATION

The key features of the CAP can be described through brief answers to five basic questions:

What is the Canada Assistance Plan?

The Canada Assistance Plan (CAP) is the set of provisions, first established by federal legislation in 1966, for the transfer of funds from the federal government to provincial governments to cover part of the cost of provincial social-welfare programs. The disbursement of these funds is administered by the Canada Assistance Plan Directorate, which is part of the Department of Health and Welfare Canada.

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What programs are covered by the CAP?

The CAP provides federal funding for a variety of provincial expenditures:

- Social-assistance payments to people 'in need'.

- Assistance for residents of homes for special care.

- Subsidies for prescription drugs, dental care, and other types of health care not covered by universal health insurance.

- Assistance to children who require foster care.

- Social services such as daycare, homemakers for the elderly, and family counselling.

- Work projects designed for people with special difficulties that prevent them from entering the labour force.

To be eligible for federal CAP funds, provincial programs must be designed to benefit those 'in need or likelihood of need' and must have some mechanism for testing the need of potential beneficiaries. (The significance of defining and testing need is discussed in later sections.)

What programs are not covered by the CAP?

The CAP legislation does not provide for federal funding of all provincial programs that might be thought of as falling into the social-welfare category. Many such programs are funded through other federal-provincial arrangements. For instance, part of the provinces' spending on health care and postsecondary education is compensated by federal funds transferred under the provisions of the established programs financing (EPF) arrangements. The costs of subsidizing some public-housing projects are shared with provincial and municipal authorities by the federal Canada Mortgage and Housing Corporation (CMHC). Federal loan assistance to postsecondary students is handled through the Canada Student Loans Plan, administered by the Secretary of State. The provinces' occupational-training programs are partially funded by the federal government under provisions of the National Training Act. (For a full catalogue of federal-provincial programs, see Canada 1983.)

How are CAP transfers determined?

In general, the federal government transfers to each province an amount equal to 50 per cent of the province's expenditure on programs eligible for assistance under the CAP. For social-services programs, however, federal transfers cover 50 per cent of the amount by which the province's spending exceeds the 1964/5 level.

Quebec formally contracted out of the CAP at its inception. However, it is compensated for expenditures on CAP programs by direct cash grants and tax-point transfers under the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act. The result is that Quebec receives exactly the amount it would receive had it remained in the CAP.

How significant are CAP transfers?

CAP transfers are not as large as other federal payments to the provincial governments. In 1982/3 CAP transfers amounted to $3.2 billion, a little more than 3 per cent of total federal government expenditures and a little less than 1 per cent of Canadian GNP. By contrast, federal equalization payments totalled $4.6 billion in 1982/3, while cash payments to finance the provinces' 'established programs' (health insurance and postsecondary education) reached $5.5 billion.

CAP SPENDING BY PROVINCE

One striking feature of the Canada Assistance Plan is the wide disparity in the transfers to different provinces. Table 1 reveals that CAP transfers in 1982/3 ranged from a high of $180 per capita to Quebec to a low of $85 per capita to Ontario. Why do such differences exist? Since the formula for most CAP transfers is 50 per cent of costs, the simplest explanation is that differences in transfers to the provinces reflect differences in their spending on CAP programs. Obviously, those provinces that spend more per capita will receive more per capita from the federal government.

The question then is why the interprovincial differences in spending are so large. To answer this question, we must take a closer look at the various CAP programs themselves.

The appropriate place to start is with general social-assistance pay-

TABLE 1
Federal CAP transfers per capita

	1977/8	1978/9	1979/80	1980/1	1981/2	1982/3[a]
Newfoundland	$71	$70	$77	$93	$105	$116
P.E.I.	62	82	84	101	132	149
Nova Scotia	57	56	64	72	83	101
New Brunswick	75	89	96	113	129	154
Quebec	94	105	116	133	154	180
Ontario	47	49	56	62	72	85
Manitoba	53	56	58	68	83	89
Saskatchewan	60	61	63	75	90	122
Alberta	60	58	62	72	107	132
B.C.	80	80	99	118	124	170
Yukon, N.W.T.	90	133	103	104	160	181
All Canada	67	72	80	92	107	130

NOTES: Per capita figures computed by dividing CAP transfers by population estimate for June of the fiscal year and rounding to nearest dollar.
a Figures for 1982/3 are based on estimates of transfers.
SOURCES: Canada (various years) *Canada Assistance Plan Annual Report*; Statistics Canada (1982).

TABLE 2
Federal transfers per capita for general social-assistance spending

	1977/8	1978/9	1979/80	1980/1	1981/2	1982/3
Newfoundland	$45	$48	$52	$59	$59	$69
P.E.I.	39	46	52	65	80	92
Nova Scotia	38	39	44	49	58	70
New Brunswick	58	76	77	91	102	121
Quebec	56	62	70	81	93	115
Ontario	33	36	38	43	49	60
Manitoba	27	30	30	33	36	46
Saskatchewan	35	40	44	46	51	67
Alberta	40	38	39	42	58	79
B.C.	49	51	63	72	79	114
Yukon, N.W.T.	34	47	47	67	76	81
All Canada	43	46	51	58	67	85

SOURCES: See Table 1.

ments to households 'in need'.[1] Since spending in this area accounts for more than 60 per cent of total CAP transfers, it is no surprise to find in Table 2 that those provinces with the highest per capita

expenditures on all CAP programs are the same provinces that spend most per capita on social assistance.[2]

Differences in the provinces' per capita spending on social assistance[3] can be attributed to three separate factors:

- Differences in the number of recipients of social assistance as a percentage of provincial population.
- Differences in benefit levels.
- Differences in the average size of households receiving social assistance.

The effects of each of these factors is worth examining.

Recipients

The most important factor in determining a province's social-assistance spending is the number of recipients. Table 3 shows that the number of social-assistance recipients as a percentage of each province's population in 1981, the last year before the recession, ranged from a high of 9.7 per cent in New Brunswick to a low of 3.5 per cent in Alberta.

Clearly, all other things (benefit levels, composition of recipient populations) being equal, those provinces with the highest recipients/population ratios will also have the highest levels of per capita spending on social assistance. This expected pattern emerges in Table 4, in which the provinces are ranked according to their per capita spending on general social assistance and their recipients/population ratios in 1981.

A thorough analysis of the forces underlying differences in provincial recipients/population ratios is beyond the scope of this paper. However, it is possible to point to the sources of these differences.

Single parents and the disabled

A close look at the segment of the population that receives social assistance is revealing. Two types of households stand out as being a much higher percentage of households that receive assistance than of all households. Families headed by a single parent accounted for 35 per cent of all social-assistance cases in Canada in 1977/8 (ITFSS 1980,

TABLE 3
Recipients of social assistance as a percentage of population

	1977	1978	1979	1980	1981	1982[a]	1983[a]
Newfoundland	9.4	9.6	7.0	8.6	8.9	9.6	
P.E.I.	7.3[a]	6.9	7.0	7.6	8.2	9.2	
Nova Scotia	6.7	5.9	5.9	6.1	7.4	7.6	
New Brunswick	9.8	9.2	9.4	9.5	9.7	9.0	
Quebec	7.3	7.4	7.5	8.0	8.3	8.7	
Ontario	4.1	4.2	4.5	4.1	4.5	4.7	
Manitoba	5.4	5.1	4.6	4.5	4.6	4.6	
Saskatchewan	4.2	4.4	4.4	4.3	4.5	4.9	
Alberta	4.5	4.3	3.9	3.6	3.5	4.0	
B.C.	6.5[a]	5.5	5.7	4.6	4.7	5.2	
Yukon, N.W.T.	8.2	8.4	9.4	9.3	12.5	11.3	
All Canada	5.7	5.6	5.7	5.5	5.8	6.1	7.3

NOTES: Percentages computed by dividing recipients as of March 31 by population estimate for June of each year.

Since each province collects its own statistics on recipients of social assistance, some portion of the interprovincial differences in this table may arise from the use of different methods of computing the number of recipients. However, it is unlikely that this explanation can account for all differences among provinces.

a Figures used for numbers of recipients are estimates only.

SOURCES: See Table 1.

TABLE 4
Rankings for recipients of social assistance as a percentage of population and by general-assistance spending per capita

	Rank	
	Recipients/population	Per capita
New Brunswick	1	1
Newfoundland	2	5
Quebec	3	2
P.E.I.	4	4
Nova Scotia	5	6
B.C.	6	3
Manitoba	7	10
Saskatchewan	8	7
Ontario	9	8
Alberta	10	9

SOURCES: See Table 1.

95), even though single-parent families made up only 7.7 per cent of all the private households counted by the 1981 census (Statistics Canada 1983c, 1-1).[4] Households headed by a disabled person accounted for 30 per cent of social-assistance cases in 1977/8 (ITFSS 1980, 95). The percentage of Canadian households headed by disabled persons is unknown, but it is likely quite small.

Although single-parent families and the disabled make up a significant portion of all social-assistance cases, their distribution across provinces can explain very little of the interprovincial differences in recipients/population ratios. Table 5 shows the overall incidence of single-parent families in all the provinces and the incidence of social assistance among single-parent families in the four provinces for which figures are available. The overall incidence of single-parent families varies only slightly from province to province. Judging from the four provinces for which figures are available, neither is there much variation in the proportion of single-parent families receiving social assistance.

If we use 30 per cent as a rule of thumb for the percentage of single-parent families likely to be on social assistance in any province, we can expect 2 to 3 per cent of each province's households to be on social assistance (30 per cent of 6.4 to 8.8 per cent, depending on the province). This range rises to 3 to 5 per cent if we include disabled recipients of assistance. This 3 to 5 per cent of households can be labelled the core population of assistance recipients in every province.

'Employables'

Interprovincial differences in the incidence of single parents and the handicapped do not appear to be great. Rather, much of the variation in provincial recipients/population ratios can be traced to another major category of social-assistance recipients: people classified as 'employable'.[5] The percentage of recipient households headed by such a person varies widely across the provinces. In 1977/8, for example, it was 48 per cent in Quebec and 37 per cent in New Brunswick, but only 17 per cent in Alberta.[6]

Thus, in provinces, such as Alberta, that have relatively few employable recipients, the recipient population consists largely of the core group of single-parent families and the disabled. It is those provinces with significant numbers of employable recipients that have high recipients/population ratios.

TABLE 5
Incidence of single-parent families, 1981

	Single-parent families/ all private households	Single-parent families on assistance/single-parent families
Newfoundland	7.2%	
P.E.I.	8.6	
Nova Scotia	8.2	
New Brunswick	8.7	
Quebec	8.8	34.3%
Ontario	7.5	29.0
Manitoba	7.2	
Saskatchewan	6.4	
Alberta	6.7	27.0
B.C.	7.0	33.3
Yukon, N.W.T.	8.1	
All Canada	7.7	

SOURCES: Statistics Canada (1983c) and annual reports of social services ministries in Quebec, Ontario, Alberta, and British Columbia.

The relatively large numbers of employable recipients in some provinces probably reflect the presence of considerable structural unemployment, which is broadly defined as an excess supply of particular types of labour that persists even during periods of rapid employment growth. Structural unemployment is thought to be more widespread in some provinces than in others; the result is that some provinces consistently have unemployment rates above the national average. It is probable that many of the structurally unemployed hold jobs so infrequently that they rarely qualify for unemployment insurance and must rely instead on social assistance. Thus, the provinces with high unemployment rates seem likely to have high recipients/population ratios, a correlation that shows up in Table 6.

The effect of the recession

Large year-to-year changes in provincial recipients/population ratios can usually be traced back to changes in the number of 'employable' recipients. That number is determined to some extent by general economic conditions. The severe economic downturn in 1982/3 undoubtedly forced large numbers of employable persons in all provinces to turn to social assistance. Tables 2 and 3 show large jumps

TABLE 6
Rankings for recipients of social assistance as a percentage of population and by unemployment rates, 1981

	Rank	
	Recipients/population	Unemployment
New Brunswick	1	2
Newfoundland	2	1
Quebec	3	5
P.E.I.	4	3
Nova Scotia	5	4
B.C.	6	7
Manitoba	7	8
Saskatchewan	8	9
Ontario	9	6
Alberta	10	10

SOURCE: Provincial unemployment rates for June 1981 taken from Statistics Canada (1983a). For comparative rankings on general-assistance spending per capita, see Table 4.

in social-assistance spending and in recipients/population ratios between 1981 and 1983. Unfortunately, complete statistics from all provinces are not yet available. The few figures available do show a dramatic rise in the number of employable recipients. For example, the Ontario Ministry of Community and Social Services' *Quarterly Statistical Bulletins* show that in that province the number of recipient households headed by employable persons increased by 58 per cent from June 1981 to June 1982 after rising only 2 per cent in the previous twelve months (Ontario, various years).

These data highlight the role of social-assistance payments as the last line of defence for workers unable to find jobs during severe recessions. Public attention has recently focused on the rising number of Unemployment Insurance exhaustees' – workers who have received UI benefits for the maximum allowable period. According to a recent study (Canada 1982), about 25 per cent of all UI beneficiaries were exhausting their claims in the period before the onset of the recession. The proportion of UI exhaustees rose to 28 per cent of beneficiaries during 1982 and was projected to rise to 30 to 35 per cent during 1983. The highest projection forecast an average of 90,000 UI exhaustees a month during 1983.

Were it true that 90,000 people were exhausting their UI claims every month, this would not necessarily mean that 90,000 more households were receiving social assistance every month. In fact, the study indicates that only 10 per cent of UI exhaustees surveyed in 1982 were turning immediately to social assistance. (This figure compares with estimates of 4 to 8 per cent made during the 1970s.)

Two major factors limit the number of UI exhaustees flowing directly to social assistance. First, about a third of them, according to the 1982 estimate, obtain employment shortly after running out of benefits. Second, about 60 per cent belong to households of which another member is employed.

A possible third factor is the conditions of eligibility for social assistance. Under the terms of the CAP legislation, federal cost-sharing applies only to assistance provided on the basis of tested need. A needs test assesses both income and assets. Thus, UI exhaustees who have savings above specified levels are usually ineligible to receive social assistance.

Youths on assistance

Young people who lack extensive employment experience are particularly prone to both structural and cyclical unemployment. Even during periods of relatively strong employment growth, workers under the age of 25 seem to have a comparatively difficult time obtaining steady employment. During recessions, young workers, who generally have the least seniority at their places of employment, are often the first to be laid off and the last to be rehired.

Thus, it is not surprising to find that, in many provinces, a high proportion of the households receiving social assistance are headed by persons under the age of 25. The most recent set of comparable figures available at the time of writing is for the fiscal year 1977/8. Table 7 shows the breakdown of recipient households in each province by age of head. At first glance, the distribution by age group seems to be fairly even. The only figures that stand out are the low percentages for households headed by senior citizens, a situation to be expected in a country that has a separate system of support for the elderly.

Once one remembers, however, that relatively few households have heads under age 25, the figures in the first column of Table 7 begin to stand out. In Table 8, where the number of recipient house

TABLE 7
Recipient households by age of head

	Under 25	25-34	35-44	45-54	55-64	65 +
Newfoundland	31%	14%	17%	15%	18%	5%
P.E.I.	14	19	17	20	23	6
Nova Scotia	15	22	18	19	24	2
New Brunswick	25	22	15	16	19	3
Quebec	20	20	18	21	17	3
Ontario	37	19	16	17	10	1
Manitoba[a]						
Saskatchewan	23	22	13	16	14	12
Alberta	24	24	16	14	17	5
B.C.	19	22	13	13	26	7
All Canada	26	20	16	18	15	4

a Figures not available.
SOURCE: Interprovincial Task Force on Social Security (ITFSS) (1980, 147).

TABLE 8
Recipient households as a percentage of all private households by age group

	Under 25	25-34	35-44	45-54	55-64
Newfoundland	59%	8%	13%	13%	16%
P.E.I.	21	9	10	13	14
Nova Scotia	18	9	9	10	13
New Brunswick	46	14	13	14	17
Quebec	34	10	11	14	14
Ontario	32	6	6	6	4
Manitoba[a]					
Saskatchewan	12	6	5	5	4
Alberta	13	6	5	5	8
B.C.	21	9	7	7	17
All Canada	26	7	7	8	9

a Figures not available.
SOURCE: ITFSS (1980); Statistics Canada (1978b).

holds is expressed as a percentage of all households for each age group, the high incidence of youthful recipients becomes clearer.

Yet the rather startling figures in the first column of Table 8 must be treated with a great deal of caution. In some cases, social-assistance payments are made to people whom the census would not count as household heads, and in some provinces, social-assistance payments made to employable persons under age 30 are so low that

most young recipients must still be living with their parents or other relatives. Therefore, it is highly unlikely that as many as 59 per cent of Newfoundland households headed by a person under age 25 are receiving social assistance.

Comparisons among the provinces are further complicated by differences in their treatment of adolescents. In 1977/8, Quebec gave very little assistance before the age of 20, so it had very few recipients under that age; other provinces, which did allow teenagers to claim benefits, had substantial numbers of such recipients.[7]

Because of the concern that apples are being divided by oranges in Table 8, we show an alternative computation in Table 9. Recipient households with heads under age 25 are simply expressed as a percentage of the population ages 15 to 24 in each province. The ratios here must also be interpreted with care. Some young people are members of assisted households that are headed by older people. Although the majority of social-assistance recipients who are under 25 are probably single, some are married. Consequently, Table 9 does not give a completely accurate statement of the percentage of 15-to-24-year-olds who receive assistance in each province. Nevertheless, it is probably safe to interpret Table 9 as indicating that a much higher proportion of the youthful population is on social assistance in some provinces than in others.

Benefit levels

Another important factor in levels of social-assistance spending is the level of benefits paid to recipients in each province. The Social Planning Council of Metropolitan Toronto (1983b) recently conducted a survey of provincial social-assistance benefits. Table 10 lists the monthly benefits paid in each province to four kinds of households.

The amounts reported in Table 10 are the sum of basic benefits and shelter payments set according to the household's shelter costs. By tying a portion of their assistance to the cost of shelter, the provinces are able to make some allowance for interregional differences in basic living costs. (The formula used to calculate shelter payments varies from province to province. Consequently, any comparison of benefit levels across provinces must be treated with some caution. The figures reported in Table 10 represent the best efforts of the

TABLE 9
Recipient households with heads under age 25 as a percentage of all persons ages 15 to 24, 1977/8

	Percentage
Newfoundland	5.0%
P.E.I.	2.0
Nova Scotia	2.1
New Brunswick	5.1
Quebec	3.8
Ontario	4.2
Manitoba[a]	
Saskatchewan	1.9
Alberta	2.3
B.C.	3.3
All Canada	3.6

a Figures not available.
SOURCE: ITFSS (1980); Statistics Canada (1983c).

TABLE 10
Monthly social-assistance payments, 1983

	Single parent with one child	Couple with two children	'Employable' single person age 30 or less	Disabled single person
Newfoundland	$542	$646	$226	$349
P.E.I.	623	865	509	549
Nova Scotia	595[a]	832[a]	341	487[a]
New Brunswick	535	575[a]	103[b]	358
Quebec	548	734	147[b]	403
Ontario	566[a]	667	313	457
Manitoba	540[a]	932[a]	324	383
Saskatchewan	735	1060[a]	522[a]	522
Alberta	700[a]	1036[a]	437	580
B.C.	640	870	375	548

a Benefits for recipients who have been classified 'long term'. Initial benefits are smaller for 'short term' recipients
b Single employable persons over age 30 receive higher benefits.
SOURCE: Social Planning Council of Metropolitan Toronto (1983b, tables 1 and 2).

Social Planning Council of MetropolitanToronto to present comparable data.)

Interprovincial differences in benefit levels may explain some of those cases in Table 4 in which the rankings of spending per capita differ from the rankings of recipients/population ratios. For instance,

British Columbia spends more per capita on social assistance than does Newfoundland, despite having a much lower recipients/population ratio, in part because British Columbia provides higher benefits.

Of course, the fact that British Columbia provides larger benefits in terms of dollars than does Newfoundland does not mean that recipients of social assistance in British Columbia are necessarily better off in terms of their ability to purchase basic necessities. Living costs vary from province to province and from region to region within provinces. In general, they are higher in large urban areas than in small towns or rural areas. The large urban areas of British Columbia are larger than the largest cities of Newfoundland. Thus, if the governments of British Columbia and Newfoundland were both aiming to raise social-assistance recipients to the same standard of living, one would expect to find British Columbia setting higher benefit levels to allow for its higher living costs.

However, interprovincial differences in benefit levels cannot be completely explained away on the basis of differences in living costs. The provinces are not jointly aiming at the same standard of living for their social-assistance recipients. Rather, each government sets its benefit levels independently. Some highly urbanized provinces provide lower dollar benefits than do others with less urbanization. In other words, interprovincial differences in social-assistance benefits are significant even if one allows for differences in living costs.[8]

Average size of recipient households

An additional factor affecting social-assistance spending totals is the average size of households receiving assistance. Benefit scales are calculated so that benefits per person decline as the size of the household rises, a design that reflects the expectation that living costs per person decline as household size increases. All other things (benefit levels, recipients/population ratios) being equal, the smaller the average size of the recipient households, the higher the per capita costs of assistance.

Table 11 shows the average number of persons per recipient household in 1977/8 as well as the number of unattached recipients as a percentage of all recipient households. To take one example, the proportion of recipient households that are made up of unattached individuals is much higher in British Columbia than in Newfoundland; consequently, the average size of a recipient household is much

TABLE 11
Size of recipient households, 1977/8

	Average size of household	Unattached recipients/ all recipient households
Newfoundland	2.7 people	43%
P.E.I.	2.5	50
Nova Scotia	2.4	45
New Brunswick	2.3	45
Quebec	1.9	59
Ontario	2.1	42
Manitoba	2.1	44
Saskatchewan	2.2	52
Alberta	2.4	39
B.C.	1.8	63
All Canada	2.0	52

SOURCE: ITFSS (1980, 145-6).

smaller in British Columbia. This difference helps push up British Columbia's per capita spending relative to Newfoundland's, despite the latter's higher recipients/population ratio.

POSSIBILITIES FOR REFORM

One can imagine alternatives to the existing CAP arrangements, and, indeed, many have been proposed. Let us examine some of these alternatives under two broad headings:

- Major shifts in federal and provincial responsibilities for social welfare.
- Minor modifications of the CAP arrangements that would leave the basic structure intact.

Shifting federal and provincial responsibilities

The current CAP arrangements leave the provinces free to establish and administer their own social-welfare programs. However, the federal government has some measure of control since provincial programs are eligible for cost-sharing only if they conform with the guidelines set out in the federal CAP legislation. Thus, one can view social welfare as an area in which the two levels of government exercise power jointly.

It is possible, however, to envision alternatives to this joint power-sharing approach. Let us examine three options:

- Unrestricted provincial power over social welfare.
- Unrestricted federal power over social welfare.
- Federal power over social assistance balanced by provincial power over social services.

Full provincial power

The rationale for a shift to full provincial control of social-welfare programs is that social welfare is one of those 'Matters of a merely local or private Nature', about which 'in each Province the Legislature may exclusively make Laws' (*Canada Act, 1867* s. 92). Cost-sharing arose because of an imbalance in federal and provincial taxing powers relative to spending responsibilities. An alternative to cost-sharing would be to shift revenue-raising powers to bring them into line with expenditure needs.

A return to unrestricted provincial power over social welfare would mean a termination of cost-sharing coupled with a transfer to the provincial governments of 'room' to tax personal and/or corporate incomes to enable them to cover the full cost of social-welfare spending.

Provinces with small tax bases and relatively high levels of per capita spending on social welfare would have to raise their tax rates substantially in order to maintain existing programs. This problem would be offset somewhat by larger equalization payments stemming from the greater importance of provincial taxation. Nevertheless, a likely long-term consequence would be greater interprovincial disparities in the levels of social assistance and services.

Full federal power

The rationale for a federal takeover of all social welfare is that the division of federal and provincial responsibilities should reflect modern realities rather than narrow interpretations of the wording of the Canada Act of 1867. According to this view, the nineteenth-century conception of social welfare as a private and local matter is now outmoded. Social-welfare policy has become a public issue of

national importance and should properly be decided at the national level.

The assumption of full federal control would require a shift in revenue-raising power away from the provinces and towards the federal government. It is possible that a federally run system could achieve greater equity in terms of assistance benefits and access to services across the country.[9]

Federal power over assistance, provincial power over services

Another option would be to draw a clear distinction between social assistance and social services. The responsibility for social assistance would be allocated to the federal government on the grounds that redistribution of income is an issue properly decided at the national level, an approach consistent with the constitutional arrangements that give the federal government control over the Unemployment Insurance and Old Age Security systems. Provincial power over social services would be consistent with the view that some public goods and services are best provided by local governments, which are able to respond to the specific demands of residents within their jurisdictions.

Since expenditures on assistance are now greater than those on services, such a move would require a slight shift of taxing power in favour of the federal government.

Reforming the CAP

Since a major realignment of federal and provincial powers over social welfare seems improbable in the near future, analysts have given greater attention to the possibility of adjustments within the existing CAP framework. The Ontario Economic Council recently (1983) published a study, entitled *Federalism and the Poor: A Review of the Canada Assistance Plan*, by Derek Hum of the University of Manitoba. Hum concludes that the existing CAP arrangements should be modified by:

- Broadening the criteria for needs-testing so that a wider range of provincial social programs can be eligible for cost-sharing.
- Introducing an equalizing element into the cost-sharing formula to

compensate provinces that have above-average recipients/population ratios.

- Financing assistance and services under separate provisions.

Redefining need

According to the present CAP legislation, only provincial programs that assist persons 'in need' are eligible for cost-sharing. Such a person is defined as:

> A person who, by reason of inability to obtain employment, loss of the principal family provider, illness, disability, age or other cause of any kind acceptable to the provincial authority, is found to be unable (on the basis of a test established by the provincial authority that takes into account that person's budgetary requirements and the income and resources available to him to meet such requirements) to provide adequately for himself, or for himself and his dependents or any of them. (*Canada Assistance Plan Act, 1966*)

In other words, the CAP requires that potential recipients of benefits pass a needs test. The household applying for social assistance must report available income and assets; eligibility for assistance is then determined according to whether its resources are below specified levels.

The provinces do have some leeway in the way in which they define and test need. Hum (1983) argues, however, that the requirement to test need has restricted the scope of provincial social-assistance programs. For example, he attributes the provinces' reluctance to expand income supplements to the working poor to uncertainty about whether such assistance would be eligible for federal cost-sharing.

Hum and others, such as David Ross (1981), point to a possible conflict between the social-assistance system and minimum-wage legislation in most provinces. As demonstrated in Table 12, social-assistance benefits for a four-person household are greater in some provinces than the income that would accrue if the head of the household obtained employment at the minimum wage. This situation occurs because social-assistance payments made by government increase with the size of the household, while wages set by the private market depend solely on the skills of the individual.

TABLE 12
Annual income from minimum wages and from social assistance for a family of two adults and two children, 1979 ($ per year)

	Annual earnings at minimum wage[a]	Net income of minimum-wage-earner[b]	Net income on social assistance[c]
Newfoundland	$5,800	$6,500	$7,200
P.E.I.	5,700	6,400	6,900
Nova Scotia	5,700	6,400	6,400
New Brunswick	5,800	6,500	6,700
Quebec	7,200	9,000	7,200
Ontario	6,200	7,200	6,900
Manitoba	6,300	7,500	8,000
Saskatchewan	7,300	8,800	6,700
Alberta	6,200	7,000	10,500
B.C.	6,200	7,000	9,100

a The provincial minimum wage, as of 31 December 1979, multiplied by 52 working weeks of 40 hours each.
b Wage earnings plus estimated value of federal family allowances and federal and provincial tax credits.
c Assistance benefits plus family allowances and tax credits.
SOURCE: Ross (1981, table 5-1).

The result is that family heads who have limited skills may be unable to obtain jobs that pay more than they can receive by relying on social-assistance benefits. Since it is difficult to develop marketable skills without employment experience, such families may be caught in a 'dependency trap'; lacking the skills to obtain a job that could make the family better off in the short run, the family head has little or no incentive to look for alternatives to assistance and no opportunity to improve skills while remaining on it.

One way to break this trap is for the government to supplement the income of a low-wage-earner so that full-time employment raises total income above what he or she would receive on assistance. The government of Quebec has used this approach in its Work Income Supplementation Plan. Under the plan, income is transferred to wage-earners who have incomes below a specified cut-off level, which depends on the size of the household. A key feature of this scheme is that the amount of the supplement *increases* with earnings for workers at very low levels of income. In other words, the income supplement offers them an extra work incentive. This provision is in sharp contrast to the tax-back approach, built into most social-assistance schemes, in which benefits fall as earnings increase.[10]

Saskatchewan's Family Income Plan (FIP) and Manitoba's Child-Related Income Supplement Program (CRISP) are also designed to provide additional income to low-income families. These programs differ from conventional social-assistance programs in that benefits depend solely on family income. Potential recipients are not required to declare their employment status or family assets on their applications. In addition, benefits are calculated so that the amount per child does not decline as the number of children rises. (See Ross 1981: 51-4, and Hum 1983: 64-7.)

The eligibility of these programs for federal cost-sharing is not clear cut because they do not use needs-testing as narrowly defined by the CAP legislation. Nevertheless, Saskatchewan and Manitoba have negotiated agreements whereby the federal government shares some of the costs of the FIP and the CRISP respectively. A similar agreement has not yet been worked out to cover the Quebec plan.

Hum (1983) believes that the provinces would establish more programs to assist low-wage-earners if federal funding for them were not so difficult. He proposes that the CAP legislation be rewritten to allow cost-sharing of such programs.

Equalizing social-assistance costs

The federal government makes equalization payments to provinces whose per capita tax bases are below the national average.[11] The rationale for this system is that all provinces should be able to provide their residents with an average level of services without having to resort to above-average rates of taxation.

The equalization system, however, takes into account only differences in provincial revenues and not differences in the costs of providing services. Yet many such cost differentials surely exist. For instance, a mountainous province faces higher costs per kilometre of highway construction than a prairie province. A province with a large proportion of senior citizens among its residents faces high per capita costs for health care. But it is one thing to describe such cost differentials in an abstract sense and another to measure them in practical terms; they have not been built into the equalization formula because of the difficulties involved in measuring them.

Table 3 displayed the wide range of recipients/population ratios across the provinces. The cost of providing an average level of social assistance is clearly greatest in the provinces with high

recipients/population ratios. Hum (1983) argues that this particular cost differential is so apparent that some type of equalization mechanism should allow for it.

His proposal is that the CAP cost-sharing be modified to compensate provinces with high social-assistance costs. Under such a formula, a province with above-average costs would receive federal transfers amounting to more than 50 per cent of its expenditures. That province could thus provide an average level of benefits without being forced to impose above-average tax rates.[12]

Separate funding of social services

The cost-sharing conditions established by the CAP legislation are broadly similar for social assistance and for social services. Under it, only those services aimed at 'the lessening, removal, or prevention of the causes and effects of poverty, child neglect, and dependence on public assistance' are eligible for federal cost-sharing. Hum (1983) argues that this conception of social services as exclusively for the benefit of the poor is outmoded. The need for a particular service may not be closely linked to either income or assets, so, in his view, narrow quantitative measures should not necessarily determine access to social services. Thus, he proposes that separate legislation provide for federal cost-sharing of provincial social services and of social assistance. Drawing such a clear distinction between the two types of programs would allow the provinces greater flexibility in the provision of social services.

A few years ago the federal government did suggest using different kinds of funding for social services and social assistance. In 1978, it proposed that cost-sharing of social services be dropped in favour of unconditional cash grants to the provinces. The grant to each would have been determined by a complicated formula based on the national average per capita of federal transfers for social services in the last year for which cost-sharing applied. Annual increases were to have been tied to GNP growth.

This formula would have placed the funding of social services on the same footing as the funding of health care and postsecondary education. The federal government would have provided funds to compensate the provinces for their expenditures on social services without explicitly requiring that such funds be used for a particular

purpose. Such a block-funding system would have given the provinces greater freedom to decide their own spending priorities.

Because block funding would have eventually equalized the per capita transfers to each province, those that spend less than the national average on social services would have benefited the most. They would have been able to expand services without raising tax rates. The federal government would also have benefited in that its fiscal planning would have been simplified, since social-services transfers would no longer have depended on provincial spending decisions. However, the strained state of federal-provincial relations and the federal government's concern that no new spending be undertaken before the 1979 election led to the withdrawal of the proposal.[13]

The income security review

The possibility of reforming the CAP cannot be discussed without mentioning the last major attempt to do so. During the 1970s, the federal and provincial governments engaged in an extensive series of discussions that became known as the Income Security Review.

The federal government initiated the process in 1970 by publishing a discussion paper outlining proposals for an overhaul of the income-security system. During the next few years, they were discussed at a number of federal-provincial meetings. Finally, at a meeting of federal and provincial social-welfare ministers in 1976, the federal government put forward a set of official proposals that would have increased basic support for those with little or no income and extended income supplements to the working poor.

The federal and provincial governments failed to reach agreement on a new system. Disagreements were sharpest over the cost of the federal proposals and how those costs should be shared. As a result, the original 1966 CAP arrangements remain basically intact. The federal government did eventually proceed on its own to introduce the refundable Child Tax Credit, and some of the provincial governments also established their own income-supplement programs.

SOCIAL ASSISTANCE AND OTHER INCOME-SECURITY PROGRAMS

Provincial social-assistance programs that are cost-shared with the federal government under the CAP are just part of the country's income-security system. Let us consider how social assistance fits in with the other programs that make up the system.

Benefits for the elderly

Income-security provisions are most extensive for people ages 65 and over. All senior citizens receive the federal Old Age Security (OAS) payment. Those with low incomes are eligible for the federal Guaranteed Income Supplement (GIS) payment – and for provincial supplements in some provinces. Many also have a claim on the retirement benefits paid by the Canada and Quebec Pension Plans (C/QPP).

This network of benefits constitutes a separate income-security system for senior citizens. As a result, the general social-assistance programs that are cost-shared under the CAP arrangements essentially cover only that segment of the population that is 64 or younger. Upon turning 65, recipients of general social assistance become eligible for the special senior-citizens' benefits.[14]

The income of a social-assistance recipient generally rises once he or she becomes eligible to receive senior citizens' benefits instead. Consider a disabled single person age 64 living in Ontario in 1983. Assuming he or she had no other source of income and no available assets, the social-assistance payment would have been $457 per month (see Table 10). He or she would also have been eligible to receive a refundable Ontario tax credit of approximately $300, yielding an annual income of roughly $5775.

Next, suppose the same disabled person had turned 65 in 1983. He or she would have received the OAS benefit of $256.67 per month (July 1983 level), the maximum GIS benefit of $257.68 per month, and the maximum Ontario supplement (GAINS) of $48.88 per month. Ontario Tax Grants for Senior Citizens would have provided an additional $570 for a total annual income of roughly $7325. Thus, one year in age can make a difference of more than $1500 in annual income as an individual moves from general social assistance to the income-security system for senior citizens.[15]

Unemployment Insurance

Social assistance and Unemployment Insurance (UI) are often discussed together under the general heading of welfare programs. This approach obscures the many differences between the two.

Most of the differences in program design can be traced to the fact that the objectives of social assistance and UI differ. Social assistance is an income-support program designed to guarantee a minimum income to those unable to reach that level on their own. Social-assistance programs allow for the link between family size and basic living costs by making benefits dependent on family size.

UI is a social-insurance or income-replacement program. The objective is to prevent the incomes of unemployed workers from falling too far below previously established levels. The structure of UI benefits reflects the concept of the program as insurance. Recipients must have established a prior claim on benefits by paying premiums (through a compulsory payroll tax paid by employers and employees) for a specified minimum period. Benefits are paid regardless of family circumstances; each benefit is related to the recipient's insurable earnings averaged over the period prior to his or her becoming unemployed. Since UI premiums are a fixed percentage of insurable earnings, the size of the benefit is related to the size of recent premium payments.

As a result, UI beneficiaries and social-assistance recipients are almost entirely different groups. UI beneficiaries must have been recently employed long enough to establish a claim on benefits. As we saw earlier, a large proportion of social-assistance recipients are not even classified as employable.

Social-assistance recipients and UI beneficiaries do, however, overlap slightly. Some families on social assistance may contain individuals who are receiving UI benefits. This situation is possible if UI benefits are the major source of family income and are low because the beneficiary's past earnings were low. The family may then be eligible to receive social-assistance payments reduced below the maximum by some fraction (known as the tax-back rate) of family income.

The number of families receiving both social assistance and UI seems to be small, at least during nonrecessionary periods. A 1979 study by the federal Department of Employment and Immigration (quoted in Kesselman 1983) estimates that every dollar saved by

cutting UI benefits 10 per cent across the board would raise social-assistance costs by only $0.06 (see Table 13).

Of course, some people do move back and forth between UI and social assistance. We have already discussed the small but rising percentage of UI exhaustees who flow directly from UI to social assistance. Movements in the other direction occur when employable recipients of social assistance find temporary employment that lasts long enough to qualify them for UI benefits.[16] Thus, in considering possible changes to UI, one must remember its interaction with social assistance.

Jonathan Kesselman (1983) proposes a number of possible UI reforms. He argues that UI works best as a pure social-insurance scheme and that the insertion of deliberate income-redistribution as a secondary objective has undesirable consequences on economic efficiency. According to strict social-insurance principles, UI benefits should be compensation for an unexpected loss of employment. Kesselman argues that under current arrangements, 'UI benefits are overly generous for persons with short, intermittent, or seasonal attachments to the labour force' (1983, xii). Under a 'pure' social-insurance scheme, the eligibility conditions would prevent seasonal workers from claiming benefits year after year.

A tightening of UI eligibility conditions would increase the number of employable recipients of social assistance. Some low-wage seasonal workers who now alternate between periods of employment and periods of receiving UI would have to turn to social assistance between periods of employment. Consequently, Kesselman emphasizes the need 'to expand income maintenance for unstable workers who are deemed needy on a family and annual basis' as a companion measure to UI reform (1983, xii).

The 1979 federal study quoted in Kesselman 1983 also considers the impact on social-assistance costs of tightening UI eligibility conditions. The estimated effects, reported in Table 13, vary widely among provinces; notice that the greatest increases in costs are expected in Newfoundland and New Brunswick, two provinces that already have recipients/population ratios well above the national average.

Clearly, any reform of UI would significantly affect federal-provincial financial relations. UI benefits are paid partially out of the general revenues of the federal government; social-assistance costs

TABLE 13
Increase in social-assistance costs per dollar reduction in UI benefits

	Change in UI benefits	
	Across-the-board 10% cut	Eligibility conditions tightened
Newfoundland	$0.11	$0.21
P.E.I.	0.05	0.10
Nova Scotia	0.07	0.14
New Brunswick	0.09	0.17
Quebec	0.06	0.11
Ontario	0.05	0.10
Manitoba	0.03	0.06
Saskatchewan	0.02	0.04
Alberta	0.03	0.06
B.C.	0.06	0.12
All Canada	0.06	0.11

SOURCE: Canada, Employment and Immigration 'An evaluation of the impact of the proposed UI changes on social assistance programs' (Ottawa: mimeo, 1979) reproduced in Kesselman (1983, 68).

are shared equally by the federal and provincial governments. Thus, any tightening of UI eligibility conditions would reduce federal expenditures and raise provincial expenditures. Provincial governments, particularly those in which social-assistance costs would increase the most, might take a dim view of UI reform unless they were compensated for the increases in their costs. Therefore, even though the federal government alone is responsible for administering UI, any proposal to reform it would almost certainly become part of wider federal-provincial negotiations.

Income supplements

Recipients of social assistance are also eligible to receive other government transfer payments, specifically income supplements that are available to a wider spectrum of the population. Examples include the federal Family Allowances (FA) benefit of $28.52 per child (as of October 1983) paid monthly to all mothers and single-parent fathers of children under the age of 18[17]; the refundable Child Tax Credit (CTC) of $343 per child per year made available by the federal government, and various refundable tax credits and direct payments made by some of the provincial governments.

These supplements play an important role in the income-security system. They are an additional source of income for recipients of social assistance. They also reach working-poor families, whose incomes are high enough to make them ineligible for social assistance, but who nevertheless may be facing considerable hardship. Moreover, since many income supplements are distributed either universally (for example, FA payments) or with income-testing through the income tax form (for example, the CTC), they avoid the social stigma attached to the 'welfare' benefits distributed by special agencies.

Income supplements also give each level of government greater freedom of action in the sphere of income security. Any government can provide supplements independently without engaging in the time-consuming intergovernmental negotiations that would be required to reform UI and/or the CAP.

In fact, some analysts have suggested a greater reliance on income supplements as a feasible substitute for a thoroughgoing reform of the income-security system should the latter prove impossible. David Ross in his book, *The Working Poor*, argues for an expanded federal CTC as a 'second-best' alternative, because he fears that 'the early 1980s are not the ideal time to be searching for federal-provincial agreement on comprehensive income security reform' (1981, 78).

SUMMARY

This paper presents an outline of the main features of the Canada Assistance Plan (CAP) and discusses some of the issues to which the CAP gives rise. These issues include the purposes of the program and what it covers, how it relates to other social-assistance programs, the groups it benefits, how CAP disbursements differ across the provinces, and finally, the main alternatives to the current CAP arrangements.

APPENDIX: OEC STUDIES ON INCOME SECURITY AND SOCIAL WELFARE

In addition to the 1983 book by Derek Hum discussed in the text of this paper, the Council has sponsored six other studies on income

security and social welfare. Another is now ready for release. Following is a brief description of each of these eight Council studies:

Denton, Frank, Leslie Robb, and Byron Spencer (1980) *Unemployment and Labour Force Behaviour of Young People: Evidence from Canada and Ontario* (University of Toronto Press for Ontario Economic Council)

This study looks at the evidence on the labour-market experience of people under age 25. The recent upward drift in the youth unemployment rate is placed in historical context by reviewing changes over time of such key variables as the labour-force participation rate. The question of whether the rise in youth unemployment has been significantly greater than the upward trend in the overall rate of unemployment is examined. Using data from the Statistics Canada Labour Force Surveys, the authors examine the effects of factors such as level of education, sex, and marital status on labour-force participation and unemployment rates. They also present demographic projections that indicate that the slowdown in the growth rate of the youth population should have a dampening effect on the youth unemployment rate.

The purpose of the study is to assess the effectiveness of government policies targeted directly on the problem of youth unemployment. The authors' general conclusion is that broader policies geared to combat unemployment in general are likely to have a greater impact than youth-specific policies.

Gunderson, Morley (1981) *Unemployment Among Young People and Government Policy in Ontario* (Toronto: Ontario Economic Council)

This discussion paper surveys the particular characteristics of the labour market for 18-to-25-year-olds, various theoretical explanations of youth unemployment, and Ontario government policies designed to deal with the problem. The purpose is to point the way to further research, rather than to arrive at hard-and-fast policy recommendations. Gunderson stresses the need for a fuller understanding of the causes of youth unemployment in order to design effective policies.

Hum, Derek (1981) *Unemployment Insurance and Work Effort: Issues, Evidence, and Policy Directions* (Toronto: Ontario Economic Council)

This discussion paper surveys the evidence from studies that have attempted to measure the effect of changes in UI's eligibility rules and benefit levels on the behaviour of individuals in the labour market. Some researchers find that the UI changes made in the early 1970s induced a significant rise in the unemployment rate, while others report little or no discernible impact. Hum attributes the differences in their conclusions to differences in their methodological approach. He then makes a case for more careful research that takes into account the particular characteristics of workers at the bottom end of the labour market who experience frequent periods of unemployment.

Hum, Derek (1983) *Federalism and the Poor: A Review of the Canada Assistance Plan* (Toronto: OEC)

This study is a comprehensive overview of the CAP's effectiveness in terms of alleviating poverty. Hum surveys the recent theoretical work on the formulation of poverty indices. He argues that in place of the simple 50-50 cost-sharing mechanism, federal CAP transfers should be linked to a formula that incorporates the incidence and magnitude of poverty in each province. He also favours broadening the CAP regulations to allow for federal cost-sharing of provincial income-supplements.

Krashinsky, Michael (1981) *User Charges in the Social Services: An Economic Theory of Need and Inability* (Toronto: University of Toronto Press for OEC)

This book investigates the theoretical rationale for providing certain in-kind benefits and goods-specific subsidies rather than income transfers. According to the conventional economic approach, providing cash transfers, which allow recipients maximum freedom of choice in the use of the additional income, is a superior method of delivering social assistance. In-kind benefits and goods-specific subsidies are often criticized as being much less efficient than cash

transfers. Krashinsky accepts the general validity of the conventional view but argues that there are cases in which in-kind benefits are the efficient means of providing for the needs of recipients with special inabilities. Within this theoretical framework, Krashinsky also looks at situations in which it may be appropriate to charge user fees for goods and services provided by government.

Krashinsky then applies his theoretical framework to the practical analysis of existing social-service programs, such as public daycare, transportation for the disabled, institutional and home-care services for the aged, and family counselling. He also discusses the problem of integrating cash-transfer programs and social services.

Mendelson, Michael (1979) *The Administrative Cost of Income Security Programs: Ontario and Canada* (Toronto: OEC)

This book focuses on six income-security programs – provincial social assistance, Workers' Compensation, municipal social assistance, Unemployment Insurance, Family Allowances, and Old Age Security. For each program, data on administrative costs going back a number of years are presented. For purposes of comparability, the administrative cost of each program is computed as a percentage of the total cost of the program.

One significant finding is that administration is responsible for only a small percentage of the total costs of income-security programs – ranging from less than 1 per cent in the case of universal demogrants, such as Old Age Security and Family Allowances, to about 5 per cent for more complex needs-tested programs, such as provincial social assistance. Thus, the potential for cost savings from more efficient administration is minimal unless the programs themselves are cut back.

Mendelson, Michael (1981) *Universal or Selective: The Debate on Reforming Income Security in Canada* (Toronto: Ontario Economic Council)

This book discusses the appropriate criteria for assessing the effectiveness of the income-security system. The advantages and disadvantages of both universal and selective methods of distributing transfer payments are examined.

Universal transfers are paid to members of some broadly defined group (senior citizens in the case of Old Age Security benefits, parents in the case of Family Allowances) on an equal basis regardless of income. Selective benefits (for example, Guaranteed Income Supplement payments made to the elderly and refundable Child Tax Credit payments made to parents) are paid on an income-tested basis with the largest payments going to those with the lowest incomes.

Mendelson compares universality and selectivity in terms of redistributive impact, administrative efficiency, social acceptability, and political feasibility. His conclusion is that selectivity is not demonstrably superior to universality. In particular, Mendelson argues that proponents of selectivity are mistaken when they claim that a switch from a universal to a selective distribution of transfers will always produce a more equitable distribution of income. He points out that a move to greater selectivity may do more to reduce the taxes paid by people with high incomes than to raise the incomes of people with the lowest incomes.

Steele, Marion (forthcoming) *An Economic Analysis of Housing Allowances* (Toronto: Ontario Economic Council)

In this study, a proposed scheme to provide cash transfers to cover a portion of the shelter costs of low-income households is compared with existing programs that provide directly subsidized public housing.

The author examines shelter-allowance programs for low-income elderly renters now in place in three provinces and assesses the feasibility of introducing a similar program in Ontario, one that could either be limited to the elderly or extended to non-elderly, low-income families. An attempt is made to estimate the costs of various shelter-allowance schemes for the Ontario government and for the federal government if a national program were to be implemented.

NOTES

1 The figures reported for spending on 'general' social assistance do not include special assistance provided to foster children and to incapacitated senior citizens. Expenditures in these areas are reported separately in the *CAP Annual Report*.

2 In British Columbia, Saskatchewan, Manitoba, Ontario, and Nova Scotia, municipal governments are responsible for providing social assistance to certain categories of recipients (principally 'employable' recipients applying for temporary

assistance). These provinces provide transfers to their municipalities to cover part of the cost of the municipally administered assistance; the federal government then shares the combined total of provincial and municipal costs. In no province does the municipal share of total social-assistance costs exceed 10 per cent.

3 It should also be noted that federal transfers to a province in a particular fiscal year may not correspond exactly with provincial spending on CAP programs in that fiscal year. Federal CAP transfers are paid out after provincial claims are processed. It is possible that full compensation for a province's total spending on CAP programs in one fiscal year may not be received until the next has begun. Some of the year-to-year variations in Tables 1 and 2 may reflect this adjustment process, rather than changes in provincial spending on CAP programs.

4 The high incidence of single-parent families receiving social assistance could perhaps best be demonstrated by a comparison with the incidence of two-parent families receiving assistance. Unfortunately, complete figures for the number of husband-and-wife families receiving assistance are not available from all provinces. However, Quebec figures show only 3.3 per cent of such families receiving assistance in 1981, while in British Columbia the percentage was 1.8. Thus, it would appear that single-parent households are about ten times as likely to be receiving social assistance as two-parent households.

5 The distinction here between 'employable' recipients and single parents and the disabled is not meant to imply that single parents and the disabled are unemployable. Many do have jobs. However, the relatively high percentages of single parents and disabled persons receiving social assistance do indicate that it is more difficult for members of these groups to become an active part of the labour force.

6 The figures for Quebec and New Brunswick are taken from Interprovincial Task Force on Social Security (1980, 95). The figure for Alberta is taken from Alberta Social Services and Community Health *Annual Report* for 1977/8. Differences in how the provinces define 'employability' may account for some of the interprovincial differences in the percentage of recipient households headed by an 'employable' person. It should also be noted that Alberta limits the period for which an 'employable' single person can receive social assistance, a regulation that may depress the number of that provinces' 'employable' recipients. However, it is unlikely that these factors can explain more than a small portion of the difference between Quebec and Alberta in numbers of 'employable' recipients of social assistance.

7 It has since become easier for teenagers to receive social assistance in Quebec. The latest figures show that 36,247 households headed by a person under the age of 20 received benefits in March 1983, compared with just 641 in 1977/8. Thus, the percentages in the under-25 columns in Tables 7 to 9 would be much higher for Quebec if they could be updated.

8 Another point worth noting is that only Quebec and Nova Scotia have put in place a mechanism to raise assistance benefits automatically in line with increases in the cost of living. The other provinces do adjust benefit levels, but there is no guarantee that these adjustments fully reflect changes in living costs.

9 Achieving equity that allowed for provincial or regional differences in living costs might be a difficult objective for the federal government. A commonly voiced

objection to allowing benefits to reflect regional differences in living costs is that no government could implement such a system without being accused of discriminating against particular regions. One way of solving this problem would be to set a basic benefit for all recipients with an additional shelter allowance determined by the actual shelter costs of each. Shelter costs are the component of overall living costs that vary most widely from region to region. Thus, a shelter allowance could go a long way towards compensating recipients who live in areas with a high cost of living and do so in a way that would be politically acceptable.

10 See Tamagno (1979) for a description of the Quebec Work Income Supplementation Plan. The 'take-up' rate of eligible recipients who actually apply for benefits under it seems to be quite low. The latest figures showed only 26,476 households receiving $19.3 million in benefits in 1982.

11 In fact, the equalization formula is quite complicated, and payments are not calculated exactly according to the average tax base across the country. However, this is approximately what happens, so the term 'national average' is used here in the interests of simplicity.

12 According to Hum (1983, 19) the Maritime provinces favoured some type of equalizing mechanism being put in place when the CAP was established in 1966. Other provinces were opposed, however, and the 50-per-cent cost-sharing formula was settled on.

13 See Canada (1978) for a description of the proposal to block-fund social services and Hum (1983, 25-6) for the story of the withdrawal of the proposal.

14 It should be noted that full OAS-GIS benefits are only paid to those senior citizens who were residents of Canada for forty years between the ages of 18 and 65. Benefits are reduced by one-fortieth for each year missing from the residency requirement. As a result, there are some low-income senior citizens who must rely on provincial social-assistance benefits.

15 The situation of a disabled person in Ontario was chosen as an example simply because Ontario is the most populous province. A gap exists in all provinces between social-assistance benefits and the minimum income guaranteed by the income-security system for the elderly. The 1983 comparison does not take account of the increases in federal GIS and provincial GAINS benefits for the single elderly that were recently announced.

16 This type of movement is especially likely to occur when temporary public-employment projects are aimed specifically at social-assistance recipients.

17 Under the terms of the federal Family Allowances Act, the provinces can have a say in setting the Family Allowances (FA) benefit-structure on the basis of family size and age of children. A province that chooses a different FA benefit-structure must ensure that each payment is at least 60 per cent of the standard federal payment and that total federal FA outlays within the province equal what would be paid out under the federal structure. Quebec and Alberta have availed themselves of this option. Quebec provides higher benefits per child to larger families and families with older children. In Alberta, FA benefits are higher for older children. Quebec also supplements federally financed FA benefits with provincially funded payments that follow a similar benefit structure.

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The impact of federal-provincial transfers on provincial revenues and expenditures: a review

Enid Slack and Douglas Crocker

Under various federal-provincial fiscal arrangements, the federal government provides transfers to the provinces for various purposes. The equalization program is designed to enable the poorer provinces to provide an average level of services without resorting to unduly high tax rates. The established programs financing (EPF) aids the provinces in maintaining national standards in postsecondary education and health care. The Canada Assistance Plan encourages provincial and municipal expenditures on welfare.[1] A variety of specific-purpose transfers are designed to stimulate spending on particular functions.

In total, federal transfers (not including tax transfers and abatements) to the provinces in 1982/3 accounted for close to $14 billion. More than $3 billion went to Ontario alone. For some provinces, such as Newfoundland and Prince Edward Island, federal transfers are more than over 50 per cent of total provincial revenues.

The magnitude of federal-provincial transfers in Canada is clearly significant, so it is important to understand their impact on the provinces' fiscal decision-making. If the provinces receive $1.00 of federal transfers, do they spend more than $1.00, less than $1.00, or just exactly $1.00? Do provincial governments spend more or less in response to transfers than in response to an increase in private incomes? If the grants have conditions tied to them, do provinces respond in the same way as they would if they were unconditional?

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Who determines the type and size of grants – is it the federal government alone, or do the provinces have some influence on these decisions? How do changes in the objectives of various levels of government affect the grant structure? Does the way in which a grant is financed make a difference to its impact?

In an effort to answer these and other questions, this paper reviews our current knowledge about the effects of intergovernmental transfers, takes a brief look at the system of federal-provincial grants in Canada, and highlights some of the important issues involved. Although no attempt is made to answer the questions empirically, we do suggest an appropriate methodology for an empirical study, setting the stage for more rigorous analysis to be undertaken in the future.

The outline of the study

The way in which a particular transfer program operates depends on the various groups involved in the decision-making process at all levels of government and also on the interaction of these and other groups. Consequently, in assessing the effects of transfers on a recipient government, the analyst has to rely on some theory or theories of political, economic, and bureaucratic behaviour. Several different theories of the decision-making process and the influence that grants have in that process have been put forward in the literature. One can distinguish four general types of models: political, bureaucratic, setter, and interactive. These models are reviewed and evaluated in the first section of this paper.

The second section summarizes the major empirical findings on the political and economic effects of transfers. In particular, it addresses the differences in impact of increased transfers and increased private incomes, the effects of conditional and of unconditional transfers, and the impact of transfers on tax effort. Although the literature shows consensus on some of these issues, the evidence is still inconclusive in many other areas.

The third section describes some important characteristics of Canadian federal-provincial transfers. Developing an appropriate model of the impact of transfers requires the identification and incorporation of relevant institutional details. For example, are grants under EPF unconditional or are some of them conditional by virtue of the Canada Health Act's restrictions on extra billing? Does

the formula for equalization grants give the provinces incentives to levy (or raise) taxes on particular revenue sources? Do the provinces play a role in determining the magnitude and nature of the transfers? Answers to these questions provide important input into the formulation of a model.

Finally, the concluding section of the paper proposes a model appropriate for estimating the impact of federal-provincial transfers on provincial decision-making. It indicates which outstanding questions most need to be addressed and suggests how one might attempt to answer them, taking into account the existing literature and Canadian institutional realities.

TYPES OF THEORETICAL MODELS

In early attempts to determine government expenditures, analysts developed estimates as a linear function of several variables, including intergovernmental transfers; they used no underlying theoretical model. For some years, however, researchers have been creating theoretical models of the impact of transfers on recipient government's expenditures and tax decisions; most of them are derived from more general models of government behaviour. In their attempt to explain government expenditures, these models use what Larkey, Stolp, and Winer (1981) call a 'market metaphor' depicting public goods as being demanded and supplied. They assume people generally act in their own self-interest, maximizing their utility subject to certain constraints, such as income, institutional rules, or the conflicting preferences of others. Most of these models assume grants increase the income of the recipient government.

Clearly, the grant process involves the participation, and often the interaction, of various individuals or groups – voters, residents, taxpayers, elected politicians, bureaucrats, and interest groups. The nature of the grants and their impact on recipient governments depends on the objectives of each of these actors, on the way in which they interact, and on which dominate the decision-making process. Models of government decision-making generally concentrate on one set of actors, but some include more than one and others analyse the interaction among groups. In this paper, we review four sets of models: political models (including voting models), bureaucratic models, the setter model, and interactive models.

Political models

Formal political models apply the theory of consumer behaviour to government behaviour. The utility of voters (or taxpayers) depends on their consumption of public goods, as well as on their consumption of private goods and on personal savings. Politicians, it is assumed, act to maximize the utility of voters, subject to a budget constraint. Voters are assumed to choose the amount of government expenditures in the same way as they choose expenditures on private goods. Transfers, in this model, do not affect utility directly but rather enter the budget constraint.

Although a consumer-utility model is appropriate for describing individuals' choices of private goods and services and personal savings, two kinds of problems arise in attempting to apply such a model to the choice of goods and services that are provided collectively to everyone: one is inherent in this kind of model, the other is procedural.

First, although decisions about private goods may be determined by the utility maximization of self-interested consumers, it is not clear that decisions about the provision of public goods are made in the same way. (For example, public goods may inspire more altruism.) Second, any such model requires some mechanism for translating individual preferences into collective choices. Existing models have used two basic methods. In one, omniscient politicians know the correct amount of goods and services to provide, for if they are not accurate, they lose the next election. In the second, it is assumed that politicians maximize the utility of the median voter because no coalition of other voters can defeat the choice of that quantity of public goods and services.

Both approaches require more examination.

Simple utility-maximization models (omniscient politicians)

In a substantial amount of the literature, the assumption is that an all-knowing politician maximizes the utility of citizens, subject to a budget restraint.[2] This assumption is not particularly appropriate, and the empirical results of models that use it do not go far in explaining some aspects of the impact of transfers on fiscal decision-making. In particular, such a model does not consider all of the

relevant actors. Moreover, in order to allow the assumption that politicians can aggregate preferences, it is necessary to assume that all citizens have the same tastes. This is a very restrictive assumption.

In use, this theoretical model establishes different effects for conditional and unconditional grants. It makes conditional grants very stimulative because they alter the price of the aided good or service; unconditional grants are less stimulative. The difference arises because conditional grants have an income and a substitution effect, both of which tend to increase expenditures, whereas unconditional grants only have an income effect.[3]

Recent studies using different methods have questioned this result. McGuire (1978), using an omniscient-political model, investigated what he terms the 'fungibility of resources'. ('Fungibility' is a term borrowed from the vocabulary of law, meaning the ability of one good to replace another of the same type.) McGuire's model indicates that conditional transfers can easily be turned into unconditional transfers. In essence, he says, when recipient governments increase their expenditures on the aided good or service, they are able to release funds from this expenditure category for use in other categories. From the point of view of the recipient government, then, either type of transfer can be used for any purpose.

Median-voter models

The median-voter model represents a more sophisticated political approach to describing expenditure decisions than does the simple utility-maximization model.[4] In the former, individual voters determine the quantity of goods that should be provided; politicians make the decisions about expenditures and tax rates. Politicians, in this view, are utility-maximizers whose primary concern is to achieve re-election by winning votes. Thus, they choose those expenditure levels and tax rates that appeal to a dominant coalition of voters. Voters also want to maximize their utility; they do so by choosing the candidate whose expenditure and tax-rate decisions most closely resemble their own.

Under these circumstances, the best strategy for a politician is to pick the expenditures and tax rates that satisfy the median voter – that is, the voter who desires the median level of expenditures and taxes. The hypothesis requires a number of simplifying assumptions:

– Each voter has one point of utility maximization; utility diminishes around it.
– Each decision is independent of all other decisions being made.
– Alternatives are chosen in a sequential process; that is, voters decide on two alternatives, and the winning one is paired against the next alternative.
– For each decision, the voter votes for his or her most-favoured alternative, without any gaming strategy.
– The ultimate decision is made by majority rule.

If all these conditions are met, no alternative can defeat the one most preferred by the median voter. Consider, for example, five voters ranked in order of magnitude of the expenditures they desire. No coalition of them can defeat the expenditure level preferred by voter 3, the median voter. Any proposal of a lower level of spending will be defeated by a coalition of the median voter and those voters who want more spending than he does (voters 4 and 5). Similarly, a coalition of the median voter and those voters who desire less than the median level (voters 1 and 2) will defeat any proposal to spend more than that level. Thus, the expenditure level chosen by the median voter is the appropriate level under conditions of majority rule.

The median-voter assumption thus allows the model based on individual utility-maximization to be adapted to the process of collective choice. The assumption of majority rule is used to transform the conflicting demands of voters into a single community demand function. The model assumes that the effective demand of the community is the median quantity of public good or service.

Some recent studies (for example, Romer and Rosenthal 1979) suggest, however, that the median-voter model actually sets the desired level of expenditures higher than the majority would prefer. The bureaucratic models and the setter model, described below, attempt to explain this phenomenon.

Voter models also make it possible to compare the effects of a lump-sum transfer to each voter and the effects of an unconditional grant to their government. Although some of the political models predict that both forms of transfer will have the same impact on private and public expenditures (see Gramlich 1977 for a review), the empirical results do not substantiate this claim. On the contrary, they

show that a grant to government generates more public spending than a comparable increase in personal income. These findings are examples of what is called the 'flypaper effect' – money 'sticks where it hits' (that is, money tends to stay in the sector, public or private, in which it is first received). Early explanations for these results were based on the fiscal illusion of voters (see, for example, Courant, Gramlich, and Rubinfeld [1979]), but more recent applications of the median-voter model suggest explanations within its own framework (see the discussion of the setter model below). The bureaucratic models also attempt to explain this phenomenon.

Bureaucratic models

The bureaucratic models make bureaucrats the principle actors in decision-making.[5] Their utility is assumed to be a function of their power and prestige, and they seek to maximize it by maximizing the size of their budgets, subject to a constraint on the total amount of funds available. Unlike the voter models, which emphasize competition, the models of bureaucratic behaviour emphasize monopoly; the bureaucrats, who want to maximize expenditures, have considerable monopoly power over the alternatives available to politicians and voters.

The bureaucrats' monopoly position enables them to appropriate from the public good they provide all the consumer's surplus of the voters (or politicians, depending on who is making the decisions) (see Beck [1981]). They do this by presenting voters with an all-or-nothing choice – purchase the quantity determined by the bureau or forgo the good altogether. The budget-maximizing bureau will choose the level of output for which the total cost just equals the total value to the consumer-voters.

The bureaucratic model addresses both the 'flypaper effect' and the possibility that actual government expenditures may exceed what the majority of voters desire. It predicts that lump-sum transfers to taxpayers will result in more private and less public spending than would unconditional transfers to their government. This outcome is the result of assuming that when bureaucrats set the level of government expenditures, they seek to maximize their own utility, rather than that of voters or taxpayers. Thus, government expenditures are greater than a majority of voters desired, and, public goods are likely provided at costs well above the minimum

attainable. The cost argument arises from the X-efficiency models (see, for example, Leibenstein [1966]), which suggest that costs are high because bureaucrats maximize their own utility functions and have no incentives to minimize costs.

A bureaucratic model is thus able to deal with 'flypaper effects' and other effects that cannot be adequately handled in the simple utility-maximization models based on the political process.

Setter models

The setter model is an extension of both the median-voter model and the bureaucratic model. Romer and Rosenthal (1978; 1979) develop a monopoly model, using an environment in which there is referendum voting on public expenditures. They assume that the bureaus that supply public goods and services are expenditure-maximizers and that voters allow them to control the agenda because setting expenditure levels requires so much information. The voters act as price takers; they can choose only between some institutionally defined expenditure, E_0, called the 'reversion level', and a proposal offered by the bureau or 'setter', E^*. If a majority of the voters approve the proposed level, E^*, these expenditures are made; if they do not approve the proposal, expenditures go to the reversion level, E_0. (In effect, these assumptions are similar to those of the bureaucratic model; the difference is that its reversion level is zero.)

Romer and Rosenthal show that, unless the reversion level is identical to the preferred point of the median voter, the setter model will predict higher expenditures than the median-voter model. The reversion level is generally taken to be the status quo – that is, the previous period's expenditure level. Romer and Rosenthal argue that, under certain assumptions, any level between the reversion level, E_0, and the proposed level, E^*, will defeat E_0 in an election. Voters will be indifferent between the status quo and a level of expenditures they consider too high, so a majority will favour any new proposal, E^1, in which $E_0 < E^1 < E^*$. When a reversion level exists (that is, when the setter can threaten to keep expenditures at the previous period's level), the expenditure-maximizing setter can achieve a level of spending much greater than the median level, E_{med}. So long as E_0 is less than E_{med} and setters seek to maximize expenditures, the enacted expenditure level will exceed what the majority of voters desire.[6]

Romer and Rosenthal (1980) are particularly concerned with using the setter model to estimate the impact of intergovernmental transfers on a recipient government's spending. In this model, one would expect the response to an increase in incomes to be different than the expenditure response to an increase in transfers because a grant alters the reversion point as well as the budget of the recipient government. (Because the setter is now obliged to spend the grant money, the reversion level is increased by the amount of the grant.) The effect of the grant on expenditures depends on the relationship between the new reversion point and the desired expenditures. For high reversion levels, the grant increase leads to more spending than an income increase does; for low reversion levels, greater spending results from increased income.

To summarize, the setter model combines aspects of both the bureaucratic and the median-voter models. It can explain the 'flypaper effect', as well as why government expenditures may be larger than desired by a majority of voters. In essence, it says that since bureaucrats have monopoly power, they can determine the alternatives available to the decision-makers in such a way that they are forced to choose the level of expenditures desired by the bureaucrats or setters. Since bureaucrats want to maximize the size of their own budgets and have no incentives for cost minimizing, these expenditures tend to be larger than voters actually desire.

Interactive models

Just as utility-maximization models replaced the early determinant studies of government expenditures, the setter model will probably replace simple utility-maximization models in explaining how grants affect government expenditures. The attraction is largely that the setter model can explain more phenomena, including the 'flypaper effect' and may even be able to test the fungibility of conditional grants (although no one has yet tested the latter capacity).

Nevertheless, the existing setter models, like the other models we have described, lack consideration of several important points. First, they do not look at the way in which changes in the objectives of the recipient government (or of the donor government, for that matter) affect the grant structure. Rather, they assume that grants are exogenous to the system. In other words, these models show grants affecting the decision-making process of the recipient government,

but they do not admit that the recipient government may influence the magnitude or type of grants being offered.

The existing models also do not consider how the grants are financed. If federal taxes financed a federal grant, logic suggests it will have an additional impact – an impact on the provincial taxpayers, who also pay federal taxes. The way in which taxes affect the economy may alter the pattern of both grants and taxes.

To address these issues – namely, the impact of the provinces' decisions on the amounts of the grants they receive and the impact of grant financing – we have to go beyond models that look only at the ways in which grants affect the recipient governments. What we need is an interactive model of the behaviour (and interaction) of federal and provincial governments.

Alm (1983) provides such a model, applying the theories of optimal taxation and production to a federal structure in order to examine the optimal structure of intergovernmental transfers. The model assumes two state governments and one federal government, which chooses the amounts of transfers to the states. Individuals in each state maximize utility, and each state government maximizes a social-welfare function of its citizens. From this optimizing procedure are derived state-reaction functions, which show the optimal level of taxes and expenditures, given federal transfers. Finally, the federal government chooses its policies (including the amount and type of grant) so as to maximize a social-welfare function of all citizens in both states. The federal government's actions have to be consistent with the optimizing behaviour of all individuals and of both state governments and are subject to a budget constraint.

Alm's model differs from those of previous studies in a number of ways. First, the analysis is normative. The model does not predict what types of transfers the federal government is likely to choose; rather it describes the grant structure that would emerge from a situation in which individuals, state governments, and the federal government maximize utility. Second, it is a simultaneous model, encompassing both donor and recipient governments, as well as individual taxpayers.

Alm does not estimate the very complicated model that results but rather performs simulations with it. His results indicate that the federal government would never use conditional lump-sum transfers because encouraging state expenditures is best done by conditional

matching grants, and equalizing fiscal capacities is best achieved through unconditional lump-sum grants. (These findings are in accord with the traditional literature on fiscal federalism.[7]) Another important, though not surprising, conclusion is that the objectives of all the governments, not only those of the federal government, influence the structure and magnitude of grants.

Although Alm's model is an advance in its consideration of the behaviour and influence of all levels of government, it uses the utility-maximization assumption discussed above and thus does not explain some important phenomena, such as the 'flypaper effect'. Future researchers might usefully consider the optimal structure of intergovernmental transfers in the context of a bureaucratic or a setter model.

Summary

This section has reviewed several different kinds of models that try to explain government behaviour, particularly the effects of transfers on government revenues and expenditures. As happens in the development of most theories, each successive model has attempted to explain phenomena that the previous model could not. The original utility-maximization models, which assumed that politicians maximize the utility of voter-taxpayers, did not prove useful in explaining why increases in intergovernmental transfers elicit more spending by recipient governments than increases in personal incomes (the 'flypaper effect'). Also, these models rested on some weak assumptions, such as politicians' knowing exactly what voters desire and being able to aggregate across individuals.

The median-voter models got around the problem of aggregation by showing that the expenditure desired by the median voter would not be defeated by a coalition of other voters. However, this model was still unable to explain the 'flypaper effect'.

Bureaucratic models of government behaviour addressed that phenomenon by introducing bureaucrats, whose objective is to maximize government expenditures, subject to a constraint on available funds. The setter model extended the bureaucratic model by introducing a reversion level of expenditures (often the status quo) as the threat bureaucrats use to obtain the level they desire. It shows, in more detail than the bureaucratic models, how and why the 'flypaper effect' works.

Finally, interactive models (none of which have actually been estimated) attempt to incorporate endogenous grants; that is, contrary to other models, they assume that grants are not determined solely by the federal government but are influenced by the behaviour of recipient governments.

The next step appears to be the development of a model that recognizes the roles of politicians, bureaucrats, and voter-taxpayers *and* the interaction among them. Such a model could test the 'flypaper effect', as well as the fungibility of conditional grants.

EMPIRICAL REVIEW

This section of the paper evaluates empirical results from various studies on the impact of intergovernmental transfers, particularly as they pertain to three relevant questions:

- Do intergovernmental grants result in more expenditures by the recipient government than does an equal increase in private income?
- Do conditional grants result in greater public expenditures by the recipient government than do equivalent amounts of unconditional grants?
- How does the existence of intergovernmental grants affect the tax effort of the recipient government?

The empirical evidence relating to each of these questions is presented in the form of a survey. Several points on what it includes and emphasizes are discussed. First, because Gramlich (1977) reviews the empirical research up to 1977, this survey concentrates on the work conducted after that year; however, it does describe most of the major Canadian studies, regardless of time they were undertaken.

Second, the survey is selective, rather than all-inclusive, for two reasons: (1) our objective is to ascertain whether the empirical literature reaches a consensus on the aforementioned questions; (2) we also seek to describe studies representative of the various theoretical models and estimation techniques.

Third, most of the recent work on the impact of intergovernmental transfers has used data from local governments in the United States. Although the American federal system is significantly different from the Canadian, the fundamental incentives an intergovernmental transfer system creates should carry over from one federal state to

another. One must be careful, though, not to apply to the Canadian situation precise estimates derived from U.S. studies. Obviously, the differences in institutional details and arrangements are likely to alter the magnitude of a transfer's effects on the recipient government. While we may gain evidence on the fundamental questions from the U.S. studies, we cannot determine exact impacts on the provincial governments without referring directly to Canadian data.

Government transfers versus increases in private incomes

The empirical literature on the impact of intergovernmental transfers has reached consensus on at least one of the basic questions. Most studies report that intergovernmental grants increase public expenditures more than would a corresponding rise in private income. In other words, money does tend to stick to the sector that receives it. While much of the theoretical literature is devoted to devising plausible theories to explain this effect, the empirical literature has had little trouble demonstrating its existence.

Initial attempts to estimate the impact of transfers on the recipient government's expenditures – that is, to estimate the 'flypaper effect' – were based on the political model, employing a social-welfare-maximization approach. Gramlich and Galper (1973), using time-series regression analysis of state and local government expenditures, estimate a long-run expenditure response of $0.43 to each dollar of unconditional budgetary transfers.[8] In other words, each additional dollar of unconditional transfer resulted in an additional $0.43 of public expenditures. Their study was significant because their model of local fiscal behaviour differentiated conditional and unconditional grants and, as we shall see later, because they made careful efforts to collect the appropriate matching rates associated with the conditional grants.

Gramlich and Galper's work was furthered by Follain (1979), whose model allows for a more sophisticated response because it permits the recipient government to alter taxes as well as expenditures. Using a pooled time-series and cross-section data set, the study estimates a set of simultaneously derived expenditure and tax equations. Follain reports that a $1.00 increase in conditional transfers for education increased the recipient governments' expenditures by $0.28. However, two of his five expenditure

categories did not increase in response to intergovernmental transfers.

Median-voter models have been used to demonstrate the 'flypaper effect'. Beck (1977) assumes local governments' expenditures on Michigan schools were determined by the preference of the median voter. He concludes that lump-sum grants were a greater stimulus to spending than equivalent increases in personal income: specifically, a $1.00 increase in lump-sum transfers, with no matching required, increased spending by $0.36. Another study by Beck (1981) reaches a similar conclusion. Using a nonlinear estimation procedure to account for endogenous transfers, he finds that a $1.00 lump-sum grant generated $0.09 of expenditures. Although this figure is not out of line with what he expected as a result of an equivalent increase in private income, Beck finds the coefficients to be significantly different. He concludes, therefore, that the stimulative effect on education expenditures is greater for lump-sum aid than for a comparable increase in personal incomes, although most political models predict little difference in the effects of the two.

In the same paper, Beck (1981) reports that the data do not support the bureaucratic model proposed by Niskanen (1971). Beck estimates the effect at a $0.20 increase in local expenditures on education for each additional $1.00 of lump-sum aid. The Niskanen model, however, suggests an increase in expenditures of more than $1.00 for $1.00 of aid.

McGuire (1981) also finds little support for the Niskanen theory of government budget-maximizing. He demonstrates that if the bureaucratic model is correct, the demand for public goods must be own-price elastic. (In other words, if the price declines by $1.00, demand would increase by more than $1.00.) McGuire examines the existing empirical literature and reports nineteen estimates of demand elasticity. Only six estimate coefficients are less than −1, indicating elastic demand; twelve estimate coefficients are between 0 and −1, indicating inelastic demand; one coefficient is positive but not significantly different from zero. These data are not consistent with a uniformly elastic apparent demand for public services. McGuire concludes, therefore, that the existing empirical evidence is not consistent with Niskanen's hypothesis that public agencies maximize their budgets. The bureaucratic model suggests that grants

increase expenditures – a finding supported by the data – but the effect is not as great as Niskanen's model suggests.

An article by Filimon, Romer, and Rosenthal (1982) examines whether one can account for the 'flypaper effect' by combining fiscal illusion with agenda control. ('Fiscal illusion' describes the situation in which voters do not, for some reason, correctly perceive the cost of public expenditures. 'Agenda control' refers to a situation in which bureaucrats propose to voters the budget to be voted on.)

Filimon, Romer, and Rosenthal posit a median-voter model in which voters may lack information regarding the amount of local budgets, and budget-maximizing agents can exercise agenda control. Their empirical work, based on a 1971 cross-section of school expenditures in Oregon, supports a model that estimates fiscal illusion alone, though adding a reversion threat significantly improves the results. Using an assumption of fiscal illusion, they find that an extra $1.00 of transfer income increased the expenditures of the recipient government by very nearly $1.00. When they drop that assumption, the 'flypaper effect' disappears, and expenditures are reduced by 25 per cent. Then they add the reversion threat, which reduced expenditures in some communities by another 15 per cent. The net result is that, assuming no fiscal illusion, an additional $1.00 grant increased Oregon school-district spending by at least $0.50.

Canadian studies

Although a large empirical literature exists on the budgetary effects of intergovernmental transfers, the number of studies using Canadian data is small. As well, Canadian empirical studies tend to differ among each other (and with U.S. studies) in expenditure categories and the level of aid. Nevertheless, several such studies have provided interesting results.

Maley (1972) pools data for the ten provinces for 1947 to 1965; her model disaggregates federal transfers into conditional and unconditional grants. The results support the notion that the grants stimulate provincial expenditures. Hardy (1976) also employs time-series data, covering 1947 to 1970, to determine the effect of federal transfers on expenditures of Ontario and New Brunswick. She finds that an extra $1.00 of intergovernmental transfers actually increased the expenditures for most categories by more than $1.00.

A study by Auld (1976) considers the effect of provincial grants on Ontario cities. Employing pooled cross-section and time-series data, he estimates equations for education, social welfare, and public works, finding that grants always increased municipal expenditures but frequently by less than the amount of the grant. The Auld study also shows the results are sensitive to the form of the utility function specified. Slack (1980) re-enforces this conclusion. One of her models shows a $1.00 increase in grants resulting in a $0.43 increase in municipal expenditures. Under an alternative specification of the utility function, the same coefficient reveals that municipal expenditures increased by more than $2.00.

Cox (1979) uses a political model and data fom Ontario, Quebec, Manitoba, and the Atlantic region. He finds that an extra $1.00 of conditional federal transfers had a significant effect on provincial expenditures in eleven of the twelve cases studied. In most categories, the estimate reveals that provincial expenditures were stimulated by more than $1.00.

Conditional versus unconditional transfers

A considerable effort has been devoted to determining whether a conditional matching grant results in significantly more expenditures by the recipient government than does an equivalent unconditional grant. This question is particularly relevant in the Canadian policy debate. Before 1977, the federal government funded spending on health care, medical insurance, and postsecondary education on a 50-per-cent cost-sharing basis. Then it introduced the present established programs financing (EPF), changing the transfer mechanism to unconditional block funding. This move raised fears about the provinces' ability to maintain the desired level of services. In essence, the concern presumes that conditional grants are more stimulative than unconditional ones because the former effectively reduce the price of the services to the provinces' suppliers.

The two mechanisms' effects on provincial expenditure decisions are, therefore, crucial. If a significant difference exists, one would expect provincial spending on health and postsecondary education under block funding to show changes from the spending under the old system of conditional transfers. If, on the other hand, no significant difference exists, federal efforts to tie transfers to specific provincial expenditures seem unnecessary.

TABLE 1
Findings of selected studies of intergovernmental transfers

Researcher(s)	Model type	Type of expenditure	Impact of extra $1.00 transfer: Uncon-ditional	Conditional
Follain (1979)	Political	Education	$0.20	$0.28
Gramlich and Galper (1973)	Political	Total	0.43	0.80
Chang (1981)	Median voter	Education	0.00	0.09
Beck (1977)	Median voter	Education	0.36	0.38
Beck (1981)	Median voter	Education	0.09	0.25
Slack (1980)	Political			
	–Stone-Geary functional form	Total	0.01	2.00
	–Translog functional form	Total	0.05	0.43

Table 1 summarizes the empirical results of those studies that differentiate between conditional and unconditional grants. All find that an additional $1.00 of conditional aid resulted in more expenditures than an equivalent amount of unconditional aid. But the estimates for both kinds of transfers cover a wide range. The impact of a $1.00 unconditional grant varies from $0.00 in Chang (1981) to $0.43 in Gramlich and Galper (1973). Similarly, the effects of a $1.00 conditional grant range from $0.09 in Chang (1981) to $2.00 in Slack (1980).

The estimates vary so much for two reasons. First, they are based on different data from different times, and the matching rates for the conditional grants were likely not the same. In other words, the institutional arrangements, other than the form of transfer itself, are likely to have been important.

Second, the estimates refer to somewhat different effects. Those reported by Follain, Chang, and Beck concern spending on education; those reported by Gramlich and Galper and Slack include all kinds of expenditures by the recipient government. One would expect total-expenditure estimates to be larger than a single-category estimate regardless of whether the grant was conditional or unconditional. An unconditional grant will increase the recipient government's expenditures on all normal public goods. A conditional grant may

increase total expenditures more than expenditures for the specified good for similar reasons; moreover, the conditions under which the money is transferred may not be binding, or more likely, the recipient government may be able to convert the conditional funds to general revenues.

McGuire (1978) explores these possibilities and provides several reasons why the nominal price of an intergovernmental grant may not reflect the true value of the subsidized programs. Basically, he suggests nominal constraints may vary depending on the needs of the recipient or on the relative bargaining positions of the two levels of government. Therefore, the nominal matching rate may not have been the effective matching rate. (The latter is a function of the degree to which conditional grants are converted to 'fungible means' – that is, to uses other than those specified by the donor government.)

McGuire comes to two conclusions. First, the ability of U.S. local governments to convert conditional grants into fungible resources increased during the 1960s. Second, the best estimate, over a range of values, indicates that \$0.74 of an additional \$1.00 in conditional-grant money was converted to fungible resources.

McGuire's study has important policy implications for the Canadian debate. It shows that shared-cost arrangements before 1977 may have stimulated expenditures not only on health and postsecondary education but also on other public services as money transferred under one program was channelled into other uses.

Two Canadian studies provide some evidence that the provinces are in fact able to convert conditional grants into fungible resources. Cox (1979) regresses regional expenditures on health, social welfare, and education, using federal grants for each category as independent variables. Of a total of forty-eight coefficients, thirty are positive and eight of these are statistically significant. For example, he finds that a conditional health grant to Ontario was a significant determinant not only of the province's spending on health but also of its spending on social welfare and on items other than health, social welfare, education, and transportation. Thus, he shows that the provinces are able, to some degree, to shift conditional grants into other expenditure categories.

A more recent article by Kapsalis (1982) argues that the change in 1977 from conditional matching grants to unconditional block

funding did not alter provincial expenditures on the services involved. He finds that the effective matching rate had been much less than the nominal rate of 50 per cent.

Tax effort

A recipient government may reduce its taxes with some of the funds it diverts away from conditional transfers (or, for that matter, with unconditional grants). Kapsalis (1982) argues that provincial spending did not decline after EPF was introduced. It is possible that the move to unconditional grants has not affected the provinces' provision of services because they are making up the difference by increasing their tax efforts.

Empirical studies of the impact of grants on recipient governments' tax efforts are mixed. Most studies consider a transfer's effects on expenditures in just one category, usually education in the United States. Since it has been demonstrated that even conditional transfers can become fungible resources, one cannot simply deduce that the impact of a $1.00 grant on the tax effort is $1.00 less the amount calculated as the impact on the specified expenditure category. In other words, if a $1.00 increase in the grant for a particular service increased expenditures on that service by $0.25, one cannot conclude that the recipient government reduced its tax effort by $0.75. It may have shifted some of the grant funds to other expenditure categories.

A few studies specifically calculate the impact of an additional $1.00 grant on the recipient government's tax effort. Follain's (1979) results indicate that grants do not significantly reduce tax effort. Rather, he concludes from his estimates, grants have virtually no effect on the tax effort. Chang (1981), however, finds an effect and concludes that the recipient government reduces its own financial support when transfers, particularly unconditional transfers, are increased. McGuire (1978) also finds that intergovernmental transfers reduce the tax effort of the recipient government. He estimates that 2 to 18 per cent of the donor's grants are returned as tax reductions and sets 15 per cent as the most likely level.

Summary

In summary, empirical studies support the propositions that:

– An intergovernmental transfer results in the provision of more public services than an equivalent increase in private incomes.

– Conditional transfers are more stimulative than unconditional transfers.

At present, however, the literature is inconclusive on whether, or to what degree, conditional transfers are converted to other uses and on how conditional or unconditional transfers affect the tax effort of a recipient government. Most of the findings just described, particularly those in the most recent work, are based on data from the United States. Many specific questions about the Canadian situation remain unanswered but are worth study.

FEDERAL-PROVINCIAL TRANSFERS IN CANADA: SOME ISSUES

Any theoretical model of the fiscal impact of federal-provincial transfers must incorporate relevant institutional aspects of the Canadian transfer system. Table 2 summarizes federal transfers to provinces and municipalities for the fiscal year 1981/2, broken down into their major components: unconditional cash payments under various programs (24 per cent of total transfers); cash transfers for established programs financing (30 per cent); conditional cash payments under various programs (17 per cent); and tax transfers and abatements (29 per cent). Several features of each of these transfers should be considered in specifying a model, or could be tested in one. Let us consider some of these features, not in an attempt to make a comprehensive list but rather to suggest the types of issues that might be relevant to a model of the impact of transfers on fiscal decision-making.

Established programs financing

Before 1977, the mechanism for federal funding of health care and postsecondary education was an open-ended matching grant: the federal government matched ('cost-shared') 50 per cent of provincial expenditures on these functions. A model of fiscal response would have to treat this grant as endogenous since its actual size was determined by provincial behaviour; the greater were provincial expenditures on health and postsecondary education, the greater were the federal grants. Moreover, since the transfer was open-

TABLE 2

Federal transfers to provinces, territories, and municipalities, 1981/2 ($000)

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.
Unconditional cash payments						
Equalization	$466,603	$111,454	$554,555	$437,713	$2,399,604	0
Statutory subsidies	9,758	670	2,259	1,836	4,677	$6,063
Municipal grants	1,650	579	12,848	3,063	47,871	100,356
Other	16,166	4,163	31,141	9,179	– 159,997	55,376
Total	$494,177	$116,866	$600,803	$451,791	$2,292,155	$161,795
Established programs financing						
Cash transfers						
Hospital insurance	$74,441	$15,973	$108,878	$90,278	$519,005	$1,043,819
Medicare	25,626	5,437	37,489	31,082	178,692	359,385
Extended health care	17,427	3,697	25,500	21,145	188,635	256,613
Postsecondary education	47,360	10,046	69,272	57,437	330,202	664,105
Total	$164,854	$34,973	$241,139	$199,942	$1,216,534	$2,323,922
Conditional cash payments						
Canada Assistance Plan	$59,462	$16,181	$70,748	$89,954	$678,675	$618,661
Economy development	35,940	19,740	55,422	44,886	97,698	33,891
Industry and trade	20,422	1,417	18,985	8,550	327	28,868
Other	11,449	1,987	23,422	27,402	129,957	122,608
Total	$127,273	$39,325	$168,577	$170,792	$906,657	$804,028
Tax transfers and abatements	$57,848	$11,708	$107,465	$80,459	$2,163,390	$1,763,220
Total transfers and tax abatements	$844,152	$202,872	$1,117,984	$902,984	$6,578,736	$5,052,965

TABLE 2 (cont'd)

	Man.	Sask.	Alta.	B.C.	N.W.T.	Yukon	Total
Unconditional cash payments							
Equalization	$404,611	$110,053	0	0	0	0	$4,484,593
Statutory subsidies	2,174	2,159	$3,497	$2,494	0	0	35,587
Municipal grants	10,845	4,119	12,371	17,646	$1,643	$872	213,863
Other	5,654	80	55,131	3,384	396	349	21,022
Total	$423,284	$116,411	$70,999	$23,524	$2,039	$1,221	$4,755,065
Established programs financing							
Cash transfers							
Hospital insurance	$130,913	$124,587	$236,841	$284,378	$4,967	$2,453	$2,636,353
Medicare	45,075	42,898	81,542	97,910	1,710	846	907,692
Extended health care	30,677	29,150	64,279	80,646	1,285	650	719,704
Postsecondary education	83,288	79,265	150,684	180,927	3,158	1,560	1,677,304
Total	$289,953	$275,900	$533,346	$643,861	$11,120	$5,509	$5,941,053
Conditional cash payments							
Canada Assistance Plan	$84,743	$87,034	$239,748	$341,441	$8,581	$2,393	$2,297,621
Economy development	18,522	26,506	5,991	23,978	2,262	1,817	366,653
Industry and trade	3,602	54,978	1,344	2,485	6,341	154	147,473
Other	23,695	62,155	26,853	33,950	1,291	2,064	466,833
Total	$130,562	$230,673	$273,936	$401,854	$18,475	$6,428	$3,278,580
Tax transfers and abatements	$152,659	$156,202	$556,364	$619,623	$8,849	$6,034	$5,683,821
Total transfers and tax abatements	$996,458	$779,186	$1,434,645	$1,688,862	$49,483	$19,192	$19,658,519

SOURCE: Public Accounts of Canada 1982 and Department of Finance transfer data. Equalization figures differ from those in the Public Accounts in that they are actual cash payments (including prior-year adjustments). The tax-transfer figures shown are estimates.

ended (that is, no limit was placed on the amount of federal funds available), this relationship between provincial expenditures and the grant was not restricted. This interrelationship would have to be reflected in a model.

In 1977, the federal government changed its funding for health care and postsecondary education from matching grants to cash transfers ('block funding') on the grounds that these important programs had already been established in the provinces and thus no longer required matching grants to stimulate spending to ensure minimum standards. This change in program design provides an interesting data series for testing the impact of a change from a conditional to an unconditional grant. A model of fiscal response could be developed and estimated using data from before and after 1977 to test for significant differences in the provinces' spending on health and postsecondary education.

The information in Tables 3 and 4 suggests some very tentative conclusions. Table 3 shows federal transfers for health care and education for 1974/5 to 1979/80. The growth in transfers before the establishment of EPF (1974/5 to 1976/7) can be compared to the growth afterwards (1977/8 to 1979/80). In total, the first period saw an increase of 33.3 per cent; it dropped only to 33.2 per cent during the second. However, a look at the table reveals some variations across provinces.

Table 4 shows the provincial governments' expenditures on health care and postsecondary education before and after the switch to EPF. Here, the changes are quite striking. In total, the growth in expenditures fell from 37.6 per cent before the institution of EPF to 21.5 per cent afterwards. In each province, the rate of growth also fell.

One can be tempted to conclude from these very preliminary numbers that the shift from a conditional to an unconditional transfer significantly reduced increases in provincial expenditures on health care and postsecondary education. However, it is crucial to develop a model to test this hypothesis since many other factors could have influenced the decline. One could argue, for example, that the late 1970s was a period of restraint during which governments were cutting back on all expenditures. Moreover, McGuire's hypothesis (1978) about the fungibility of conditional transfers leads one to question any conclusion drawn from Table 4 alone; parts of the

TABLE 3
Federal transfers for health care and postsecondary education($000)

	1974/5	1975/6	1976/7	% change 1974/5-1976/7
Newfoundland	$82,325	$91,562	$109,742	33.3%
P.E.I.	15,175	17,974	21,431	41.2
Nova Scotia	127,060	155,766	175,893	38.4
New Brunswick	100,008	116,649	136,234	36.2
Quebec	1,234,772	1,395,339	1,529,352	23.9
Ontario	1,408,463	1,694,716	1,933,589	37.3
Manitoba	164,811	192,356	222,439	35.0
Saskatchewan	141,004	166,899	197,960	40.4
Alberta	315,578	405,351	433,941	37.5
B.C.	373,710	507,114	520,215	39.2
Total	$3,962,876	$4,693,726	$5,280,796	33.3%

	1977/8	1978/9	1979/80	% change 1977/8-1979/80
Newfoundland	$135,160	$161,438	$186,052	37.7%
P.E.I.	25,659	33,080	40,278	57.0
Nova Scotia	210,265	254,386	293,151	39.4
New Brunswick	163,211	202,492	237,478	45.5
Quebec	1,872,778	2,192,503	2,386,312	27.4
Ontario	2,515,823	2,961,064	3,323,478	32.1
Manitoba	280,404	331,590	377,374	34.6
Saskatchewan	251,866	300,472	352,146	39.8
Alberta	576,673	669,517	768,709	33.3
B.C.	709,635	850,119	1,008,981	42.2
Total	$6,735,474	$7,956,661	$8,973,959	33.2%

SOURCE: Public Accounts of Canada (various years).

TABLE 4
Provincial governments' expenditures on health care and postsecondary education ($000,000)

	1974/5	1975/6	1976/7	% change 1974/5-1976/7	1977/8	1978/9	1979/80	% change 1977/8-1979/80
Nfld.	$211	$256	$265	25.6%	$275	$305	$339	23.3%
P.E.I.	36	45	51	41.7	67	68	73	9.0
N.S.	310	360	401	29.4	489	480	525	7.4
N.B.	212	280	301	42.0	336	369	407	21.1
Que.	2,545	3,183	3,609	41.8	3,915	4,417	4,955	26.6
Ont.	3,483	4,076	4,492	29.0	4,902	5,334	5,667	15.6
Man.	404	493	561	38.9	731	637	687	-6.0
Sask.	307	383	462	50.5	565	537	611	8.1
Alberta	778	1,033	1,236	58.9	1,375	1,451	1,712	24.5
B.C.	948	1,223	1,320	39.2	1,466	1,739	2,029	38.4
Total	$9,249	$11,354	$12,730	37.6%	$14,031	$15,381	$17,046	21.5%

SOURCE: Statistics Canada, Provincial Government Finance (various years).

conditional transfers of the earlier period could have been converted to other expenditure categories.[9] The federal government also felt that expenditures would not fall because the programs were already established.

Whether EPF can be treated as an unconditional transfer is another question. The new Canada Health Act stipulates that provinces that allow extra billing for health services will have their EPF transfer reduced accordingly. Thus, EPF may not be a true unconditional transfer. Rather, it is a lump-sum transfer (not a matching transfer, as previously) with a conditional aspect that may restrict provinces from reducing their expenditures on health. Since the expected response to conditional and unconditional transfers may be different, a model-maker must stipulate which form EPF takes.

Equalization payments

Equalization grants are unconditional transfers to the poor provinces, with 'poor' measured by the fiscal capacity of the provinces in a test based on approximately thirty categories of provincial taxes. The latest formula, the 'representative five-province standard', equalizes fiscal capacity up to the average of five provinces (British Columbia,

Saskatchewan, Manitoba, Ontario, and Quebec). As Courchene (1984) notes, provinces are likely to try to maximize the equalization grants they receive. One method is to levy higher taxes on some of the categories of revenue in which it has been classified as poor. The significance of this point for studying the impact of transfers is that the model must incorporate both the behaviour of federal and provincial governments and the interaction between them. Federal equalization payments obviously affect the provinces' expenditures and revenues. On the other hand, the provinces' fiscal behaviour also affects the federal government's decisions on equalization payments. Thus, a simultaneous or interactive model is required.

The equalization formula has changed often since its inception in 1957. The tax bases used in it have varied from the three standard taxes (personal income tax, corporate income tax, and succession duties) to more than thirty. The standard for equalization has varied from the average for the richest provinces to the average for the whole country to the average for five 'representative' provinces. Despite these changes and changes in the provinces' relative economic positions over time, the distribution of equalization transfers has changed only very gradually. Table 5 shows that, between 1974/5 and 1981/2, the percentage shares changed only slightly for most provinces and a little more for Manitoba and Saskatchewan. One could thus argue, as Courchene (1984) does, that the formula may be determined by the desired outcome, rather than the outcome being determined by the formula.[10]

For modelling, then, one would have to know how the provinces' revenues and expenditures affect the amounts they receive as well as how the transfers affect their revenues and expenditures. It would also be useful to know the ways in which they use means other than decisions about expenditures and taxes to affect their have-not status. For example, how do politicians and bureaucrats at both levels of government interact? For this reason, too, an interactive model is required.

Goals and approaches

Two additional points can be made about modelling federal and provincial government behaviour with respect to the granting process. One concerns goals such as visibility and accountability, the

TABLE 5
Distribution of equalization payments

	1974/5	% of total	1975/6	% of total	1976/7	% of total	1977/8	% of total
Nfld.	$186,631	10.4%	$192,720	9.9%	$226,220	10.4%	$272,024	10.8%
P.E.I.	40,503	2.3	48,765	2.5	59,943	2.8	62,270	2.5
N.S.	215,765	12.0	282,635	14.5	291,555	13.4	365,456	14.5
N.B.	172,941	9.6	204,704	10.5	213,493	9.8	279,185	11.1
Que.	974,717	54.3	1,007,828	51.5	1,189,511	54.8	1,277,500	50.7
Ont.	0	0.0	0	0.0	0	0.0	0	0.0
Man.	121,993	6.8	150,468	7.7	171,433	7.9	220,382	8.7
Sask.	82,418	4.6	63,329	3.2	17,127	0.8	39,386	1.6
Alta.	0	0.0	0	0.0	0	0.0	0	0.0
B.C.	0	0.0	0	0.0	0	0.0	0	0.0
Total	$1,794,968	100.0%	$1,956,449	100.0%	$2,169,282	100.0%	$2,521,203	100.0%

TABLE 5 (cont'd)

	1978/9	% of total	1979/80	% of total	1980/1	% of total	1981/2	% of total
Nfld.	$315,768	12.0%	$340,013	10.3%	$387,293	11.0%	$466,603	10.4%
P.E.I.	66,927	2.5	74,071	2.2	88,438	2.5	111,454	2.5
N.S.	370,547	14.1	408,775	12.4	454,163	12.8	554,555	12.4
N.B.	308,538	11.7	370,447	11.2	332,845	9.4	437,713	9.8
Que.	1,331,543	50.6	1,708,593	51.6	1,847,169	52.2	2,399,604	53.5
Ont.	0	0.0	0	0.0	0	0.0	0	0.0
Man.	220,287	8.4	366,067	11.1	403,990	11.4	404,611	9.0
Sask.	18,748	0.7	41,622	1.3	23,537	0.7	110,053	2.5
Alta.	0	0.0	0	0.0	0	0.0	0	0.0
B.C.	0	0.0	0	0.0	0	0.0	0	0.0
Total	$2,632,358	100.0%	$3,309,588	100.0%	$3,537,435	100.0%	$4,484,593	100.0%

SOURCE: Public Accounts of Canada (various years).

other the 'gamesmanship' that becomes evident in federal-provincial fiscal negotiations.

As Courchene notes elsewhere in this volume,[11] the federal government is interested in visibility and accountability in its relations with the provinces. In pursuit of these goals, it is likely to opt increasingly for conditional transfers since in addition to allowing the donor to maintain control over the recipient's expenditures, this type of transfer can make the donor visible, and presumably accountable, to taxpayers.[12] This phenomenon does not directly affect empirical testing of the fiscal impact of transfers, but it might shed some light on the interaction between the federal and provincial governments with respect to granting funds, the optimal structure of transfers, and the determinants of grant amounts.

In a model in which the grants system is endogenous, the interaction between the federal and provincial governments for the determination of grants plays an essential part. One can imagine the federal government threatening to cut off transfers if certain conditions are not met (which is essentially what Ottawa has done in regard to extra billing for health services). One can also imagine the provinces demanding certain kinds of transfers and certain amounts and threatening to pull out of the tax-collection agreements if they do not receive what they want. If the provinces did pull out, they would collect their own personal income taxes (as Quebec does now), rather than piggybacking onto the federal tax system.[13] The resulting grant system would depend, in this model, on the dominance of various provinces and the federal government and on the viability of the threats. This approach, however, would be very difficult to model.

Summary

Several institutional features of the Canadian federal-provincial transfer system affect the impact of these transfers on provincial revenues and expenditures. This section has highlighted some of them, stressing their importance in the final outcome of who gets what grants and what they do with them. It is not likely, however, that one model could be used to answer all of the questions posed here.

CONCLUSION

Ideally, one would posit an interactive model of the whole Canadian federal-provincial fiscal system and the impact of grants on that system. A model of this sort would allow one to look at the decision-making process for the granting of funds and determine the optimal amounts and types of grants. However, since such an empirical model has never been created and since its requirements for data would be very stringent, it would prove very difficult to estimate. However, it should be possible to do some useful work on a smaller scale.

Most of the models tested in the Canadian situation have been political models in which all-knowing politicians maximize the utility of voters subject to a budget constraint. The data series used have generally been fairly old. Thus, one important avenue for further empirical research would be the application of a setter model to recent data to test the impact of federal-provincial transfers in Canada. In particular, the fundamental change in transfers for health services and postsecondary education since 1977 and the current interest in the conditionality of EPF as applied to health costs seem to have created a good opportunity to test the fungibility of conditional transfers in a model of this sort.

It would thus be useful, at least as an initial step, to derive a model, like the setter model, of provincial fiscal decision-making to test the impact of conditional and unconditional transfers on spending on health care and postsecondary education. Transfers, at least those before the introduction of EPF, would be endogenous in this model, and one could test for any significant differences in expenditures before and after EPF came into effect.

Such a project would not be as ambitious as formulating an interactive model, but it would provide some interesting results on a yet unresolved issue that is very relevant to the Canadian situation. If the model provides strong results, it could perhaps be extended to consider other issues.

NOTES

1 These programs are described in detail in several other conference papers and are thus mentioned only briefly here.
2 For a review of these studies, see Slack (1980) or Gramlich (1977).
3 See Wilde (1971) for a theoretical discussion and Slack (1980) for an empirical application.

4 The earliest work on median-voter models is that of Downs (1957), with empirical application by Barr and Davis (1966).
5 They started with Niskanen (1971).
6 This summary of Romer and Rosenthal (1978; 1979) is based on Larkey, Stolp, and Winer (1981).
7 For a discussion of the rationales for transfers and the most appropriate ones to use to achieve particular objectives, see Bird and Slack (1982).
8 Most of the studies reported here do not estimate the increase in public expenditures that would result from a $1.00 increase in private income. In general, however, the studies from the United States seem to accept that public expenditures would increase by $0.10.
9 Moreover, when the new transfer mechanism was instituted, its design meant that some provinces faced reduced grant funds and others did not. One would, of course, expect the change to have a different impact in those provinces whose grant funds were reduced and those whose grant funds remained the same.
10 For example, in 1977, when Ontario became a 'have-not' province according to the formula, it was changed to reduce the impact of oil revenues on equalization payments.
11 See Courchene, 'The fiscal arrangements: focus on 1987'.
12 See Bird and Slack (1982) for a discussion of which types of grants serve which purposes.
13 For a complete discussion of the implications for Ontario of levying its own personal income tax, see Hartle and others (1983).

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